AUDIT REPORT



AUDIT OF APREVA, INC.,

NON-SUPERVISED MORTGAGEE

2004 SE 1006

August 19, 2004

OFFICE OF AUDIT, NORTHWEST/ALASKA REGION SEATTLE, WASHINGTON



Issue Date

August 19, 2004

Audit Case Number

2004-SE-1006

TO: John C. Weicher, Assistant Secretary for Housing-Federal Housing Commissioner, H, and

Margarita Maisonet, Director, Departmental Enforcement Center, CV

FROM: Frank E. Baca, Regional Inspector General for Audit, 0AGA

Frat E. Sacre

SUBJECT: Audit Report Apreva, Inc.

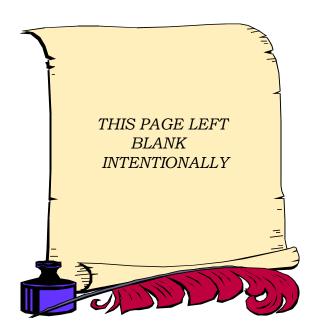
Non-Supervised Mortgagee Bellevue, Washington

We completed an audit of Apreva, Inc., a non-supervised mortgagee located in Bellevue, Washington. We selected Apreva for review because of their high default and claim rates. Our report contains three findings with recommendations requiring action by your office.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without a management decision, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after report issuance for any recommendations without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

We appreciate the courtesies and assistance extended by the management and staff of Apreva, Inc.

Should you or your staff have any questions, please contact me at (206) 220-5360.



Executive Summary

We completed an audit of Apreva, Inc. in Bellevue, Washington. Apreva is a non-supervised mortgagee approved by HUD to originate and approve FHA-insured loans under HUD's Single Family Direct Endorsement Program.

The audit objectives were to determine if (1) Apreva complied with HUD regulations, procedures, and instructions in the origination and approval of Federal Housing Administration (FHA) loans, and (2) Apreva's Quality Control Plan, as implemented, met HUD requirements. The review covered the period from January 1, 2001 to March 1, 2003.

Apreva Ignored HUD/FHA Requirements Apreva repeatedly ignored HUD/FHA requirements. Specifically, Apreva:

- Did not follow HUD regulations and other requirements when underwriting and approving loans for FHA insurance endorsement. We reviewed 39 loans, totaling over \$5.6 million, that had defaulted within the first six payments and were currently either in foreclosure or had claims processed. We found that 38 of these loans had serious underwriting deficiencies. (Finding 1)
- Entered into prohibited agreements with independent mortgage companies or individuals to act as branches and/or employees to originate FHA-insured loans. These agreements contained provisions that violated HUD/FHA requirements by (1) stating that the loan officers must supply all tools, equipment, and supplies, and/or (2) requiring loan officers to indemnify Apreva for any error or legal violation committed in the loan origination process. (Finding 2)
- Did not conduct required quality control of FHA loan originations. Specifically, Apreva did not (1) timely implement its Quality Control Plan after receiving HUD/FHA approval, (2) always perform the required review of ten percent of its loans, and loans defaulting within six months, (3) take prompt and effective corrective action after identifying numerous deficiencies, or (4) adequately supervise its loan correspondents. In addition, Apreva allowed loan correspondents to originate loans under Apreva's identification number. (Finding 3)

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Recommendations

We are recommending that HUD remove Apreva from participation in FHA's Single Family Mortgage Insurance Programs, and impose civil money penalties for its violations of HUD requirements. In addition, HUD should take appropriate administrative sanctions against Apreva's President, Chief Executive Officer, and Senior Underwriter.

We are also recommending HUD require that Apreva repay insurance losses on claims totaling \$1,366,483 and indemnify HUD/FHA against future losses on loans totaling \$2,867,722 identified as having serious underwriting deficiencies; originated by ineligible branches or employees and in default or claim status; and on other loans identified in this report that were otherwise not processed and quality controlled, as required.

Apreva Disagreed With Audit Findings and Recommendations We issued a discussion draft report on May 21, 2004, and discussed the audit results with Apreva's Chief Executive Officer at an exit conference on June 29, 2004. Apreva provided written comments to the draft report on July 14, 2004, disagreeing with the findings and recommendations. Appendix B of this report contains Apreva's written comments followed by our evaluation of the written comments.

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Abbreviations

FHA	Federal Housing Administration
HOC	Homeownership Center
HUD	U.S. Department of Housing and Urban Development
MCAW	Mortgage Credit Analysis Worksheet
ML	Mortgagee Letter
OIG	HUD Office of Inspector General
QAD	Quality Assurance Division
QC	Quality Control
QCP	Quality Control Plan
URLA	Uniform Residential Loan Application
VOD	Verification of Deposit
VOE	Verification of Employment

Introduction

Background

Apreva, Inc., doing business as Apreva Funding, was incorporated under the laws of the State of Washington on January 6, 1998. Apreva received approval from HUD as a Title II non-supervised mortgagee on July 31, 1998 with its main office in Olympia, Washington. Between June 2000 and September 2001 Apreva reorganized when two of the three original owners sold their interest to a new co-owner. In the fall of 2003 Apreva notified HUD that the main office was relocated to Bellevue, Washington. As a non-supervised mortgagee, Apreva underwrites and originates mortgage loans under the HUD/FHA Single Family Direct Endorsement Program. Apreva also underwrites Veterans Administration guaranteed and conventional loans.

During our audit period of January 1, 2001 to March 1, 2003, Apreva underwrote 2,795 FHA-insured single family loans, representing over \$414 million in insurance exposure within Washington and Oregon.

Audit Objectives

The audit objectives were to determine if Apreva complied with HUD regulations, procedures, and instructions in the origination and approval of Federal Housing Administration (FHA) loans, and whether Apreva's Quality Control Plan, as implemented, met HUD requirements.

To accomplish our audit objectives, we:

- Reviewed the FHA case files for 39 FHA-insured loans underwritten by Apreva. We selected these 39 loans because the borrowers defaulted within six months of closing and the loans went into foreclosure. The 39 loans were from the universe of 2,795 loans underwritten by Apreva with beginning amortization dates between January 1, 2001 and March 1, 2003. The results of the detailed testing apply only to the 39 loans selected and cannot be projected to the entire universe of 2,795 loans.
- Analyzed reviews performed by HUD's Quality Assurance Division and Santa Ana Homeownership Center's (HOC's) Processing and Underwriting Division.
- Examined records at Apreva, including loan origination files, loan origination logs, employee listings, accounting records, and personnel files.

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- Reviewed Apreva's Quality Control Plan and Quality Control reports.
- Interviewed Apreva officials and employees.

Our audit covered the period January 1, 2001 to March 1, 2003.

We performed the audit in accordance with Generally Accepted Government Auditing Standards.

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Apreva Approved FHA-Insured Single Family Loans Containing Serious Underwriting Deficiencies

We reviewed 39 Apreva loans, totaling \$5,627,503, that had defaulted within the first six payments and were currently either in foreclosure or had claims processed. We found that 38 of the 39 loans had serious underwriting deficiencies. The underwriting deficiencies occurred because (1) Apreva personnel, especially the Senior Underwriter, did not ensure that the loans were processed in accordance with HUD/FHA requirements, and (2) Apreva's management failed to implement corrective action even after repeatedly being notified of the underwriting deficiencies. HUD/FHA assumes an unnecessary insurance risk when unqualified borrowers receive mortgage approval.

HUD Handbook Requirements Section 203 of the National Housing Act (12 U.S.C. 1709) states that HUD insures mortgages made by private lending institutions. Dependent upon their designation by HUD, the institutions have the authority to originate, purchase, sell, or service HUD/FHA insured mortgages.

Under HUD's Single Family Direct Endorsement Program, the mortgage underwrites and closes the mortgage loan without prior HUD review or approval. HUD Handbook 4155.1 REV-4 CHG-1 contains the basic mortgage credit underwriting requirements for single family (1-4 unit) mortgage loans insured under the National Housing Act.

Paragraph 2-1 of HUD Handbook 4000.4 REV-1, *Single Family Direct Endorsement Program*, requires mortgagees to develop HUD/FHA insured loans in accordance with accepted sound mortgage lending practices. Paragraph 2-5 provides that the mortgagee must obtain and verify information with at least the same care that would be exercised in originating the loan in which the mortgagee would be entirely dependent on the property as security to protect its investment.

HUD Handbook 4155.1 REV-4, *Mortgage Credit Analysis for Mortgage Insurance*, describes the basic mortgage credit underwriting requirements for single family mortgage loans insured under the National Housing Act. For each loan HUD insures, the lender must establish that

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the borrower has the ability and willingness to repay the mortgage debt. This decision must be predicated on sound underwriting principles consistent with the guidelines, rules, and regulations described throughout the Handbook, and must be supported by sufficient documentation.

Paragraph 9-2 of HUD Handbook 4150.1 REV-1, Reviews of Appraisal Reports, requires the underwriter or other reviewer to review each critical area of the appraisal for anything that appears unreasonable. If the reviewer notes any areas that are inconsistent or otherwise unacceptable, the report needs to be returned to the appraiser for correction, or the reviewer can modify or amend the report according to HUD valuation policy.

Inadequate Loan
Underwriting Practices
Resulted In Unqualified
Borrowers Being
Approved for HUD/FHA
Insured Loans

Our review of 39 loans that went into default within the first six payments disclosed that, for 38 of the loans, Apreva personnel did not follow all applicable HUD/FHA underwriting requirements. Apreva has already signed indemnification agreements for three of these loans as a result of reviews performed by HUD's Quality Assurance Division or HUD's Processing and Underwriting Division. Our review of the remaining 35 loans found that Apreva did not:

- Provide valid or sufficient compensating factors when HUD/FHA's benchmark debt to income ratios of 29 and 41 percent were exceeded (26 loans),
- Document the stability of borrower income in accordance with HUD/FHA requirements (22 loans),
- Properly verify the source of funds used for the downpayment and/or closing costs (30 loans),
- Ensure compliance with HUD/FHA borrower credit requirements (19 loans),
- Review appraisals in compliance with HUD/FHA requirements and/or resolve appraisal irregularities (13 loans), or
- Clarify and/or adequately document important file discrepancies (28 loans).

Specific examples of Apreva's poor underwriting include:

- FHA case file number 431-3581581. Apreva approved a buydown interest rate loan with mortgage payment to income ratio of 46.13 percent and a total fixed payment to income ratio of 46.79 percent, without documentation of compensating factors to justify the high ratios. Furthermore, the underwriter (1) understated the ratios because income and liabilities weren't properly evaluated, (2) did not properly analyze borrowers' funds, and (3) failed to ensure that the source of funds from a Downpayment Assistance program were adequately verified and documented. The borrowers defaulted after making four payments.
- FHA case file number 561-7187129. Apreva's underwriter approved a loan with a 43.11 percent total fixed payment to income ratio without documentation of compensating factors to justify the high ratio. In addition, the underwriter did not ensure that there was adequate verification of funds and sufficient funds to close. Further, the underwriter did not properly analyze the borrower's ability to make the mortgage payments. Information in the case file showed that the borrower was unable to accumulate savings and, with the new loan, the borrower faced a \$633 increase per month in housing costs. The borrower defaulted after making two payments.
- FHA case file number 561-7286022. Apreva did not properly evaluate the borrowers' ability to repay the mortgage. The loan was approved with a high mortgage payment to income ratio of 33.25 percent, a \$1,021 increase per month in housing costs, lack of borrower savings ability, and poor credit history. Furthermore, the underwriter (1) understated the ratios because borrower income wasn't properly evaluated, (2) failed to properly analyze the borrowers' assets and credit, and (3) failed to ensure that the source of funds from a Downpayment Assistance program was adequately verified and documented. The borrowers defaulted after making four payments.

As of March 31, 2004 the status of the 38 loans is as follows:

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C4-4	Number of	Loan
Status of Loans	Loans	Amounts
Indemnification agreement		
signed by Apreva	3	\$467,812
Delinquent	1	\$137,738
Reinstated to Mortgagor	1	\$131,929
In Process of Foreclosure	6	\$849,451
Property Conveyed to Insurer	27	\$3,868,429
Total Loans	38	\$5,455,359

Appendix C to this report provides a summary of the loan underwriting deficiencies noted during our review. These deficiencies have caused FHA fund losses totaling \$1,366,483 and potential losses of \$1,234,310. Detailed results of our review will be provided under separate cover.

HUD's Quality Assurance Division (QAD) also identified similar underwriting problems at Apreva. Due to high default rates, QAD performed Title II monitoring reviews of five of Apreva's Loan Correspondents between July 2002 and July 2003. The findings letters prepared by QAD disclosed serious violations relating to HUD/FHA underwriting requirements. Specific violations are listed in Appendix C.

Apreva's deficient underwriting practices occurred because (1) Apreva representatives, in particular its Senior Underwriter, did not adhere to HUD/FHA underwriting requirements, and (2) Apreva's management failed to take corrective action when notified of the poor performance of its Senior Underwriter. (See Finding 3)

Beginning in 1998, HUD performed post endorsement technical reviews of 330 Apreva loans with beginning amortization dates from the second quarter of 1999 through the third quarter of 2003 (April 1999 through September 2003). Through June of 2000, the post endorsement technical reviews of Apreva loans resulted in a poor rating for mortgage credit analysis on 18 percent (7 of 40) of the loans reviewed.

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Changes in Corporate
Management and Hiring
of Apreva's Senior
Underwriter Led to
Approval of Loans With
Serious Underwriting
Deficiencies

In June of 2000, Apreva expanded its business operations by hiring a new manager and his staff for a new wholesale office in Bellevue, Washington. During the following year the Bellevue manager became a co-owner and is currently the CEO. One of the staff hired was a Senior Underwriter, whose duties included underwriting loans as well as training and providing underwriting guidance to other underwriting staff hired by Apreva.

After Apreva brought on the new Bellevue staff, the percentage of poor ratings for mortgage credit analysis sharply increased. From July 2000 through September of 2003, poor ratings jumped to 87 percent (251 of 290) of the loans reviewed. At the same time, the percentage of Apreva loans with good post endorsement technical review ratings for the underwriter's review of appraisal and valuation documents and closing documents decreased. Prior to July of 2000, Apreva's closing ratings were good for 88 percent (35 of 40) of the loans reviewed. After hiring the new staff, the good ratings dropped to only 15 percent (44 of 290) of the loans reviewed. Similarly, after July 2000, HUD's post endorsement technical review ratings for underwriter's review of valuation (appraisals) decreased from 67 percent (26 of 39) good to 17 percent (49 of 285) good of loans reviewed.

On June 10, 2003, HUD's Santa Ana Home Ownership Center sent a letter to Apreva addressing the Senior Underwriter's continuing poor underwriting performance. The letter stated that loans underwritten by the Senior Underwriter received nine poor ratings between January 1 and March 31, 2003. The items noted in the post endorsement review letter are consistent with those items noted during our review of Apreva's underwriting and illustrates the Senior Underwriter's continuing failure to fully conform with HUD/FHA underwriting requirements.

Further, as described in Finding 3, Apreva management did not take appropriate action to correct and prevent underwriting deficiencies identified in its own quality control reviews. Apreva's management allowed its Senior Underwriter to continue approving loans even though Apreva's own Quality Control reports and HUD repeatedly identified poor underwriting performance. These deficiencies resulted in Apreva approving loans for

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unqualified borrowers, causing an unnecessary risk to the HUD/FHA insurance fund.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, Chairman, Mortgagee Review Board

- **1A.** Remove Apreva, Inc. from participation in HUD's Single Family Mortgage Insurance Programs based on Apreva's pattern of non-conformance with program requirements, reported in Findings 1, 2 and 3.
- **1B.** Require Apreva to reimburse HUD/FHA for \$1,366,483 of claims paid, and indemnify HUD/FHA against future losses on loans totaling \$1,234,310 identified in Appendices A and C of this report.
- **1C.** Impose civil monetary penalties on Apreva, as applicable, for the underwriting deficiencies described in this finding.
- **1D.** If HUD determines that Apreva, Inc. can maintain its approval as a non-supervised mortgagee (see Recommendation 1A.), require Apreva to provide your office with a corrective action plan to assure that its staff follow all guidelines regarding the underwriting of HUD/FHA insured loans.

We recommend that the Departmental Enforcement Center:

- **1E**. Seek appropriate administrative sanctions against Apreva's President and its Chief Executive Officer based on Apreva's pattern of non-conformance with program requirements, reported in Findings 1, 2 and 3.
- **1F**. Seek appropriate administrative sanctions against Senior Underwriter identification number 4706.

Apreva, Inc. Allowed Ineligible Branches and Non-Employees to Originate Insured Loans

Contrary to HUD/FHA requirements, Apreva acted as a conduit for loans originated by unapproved branches and independent loan officers who were not Apreva employees. Apreva disregarded HUD/FHA requirements and entered into agreements with independent mortgage companies and individuals to act as branches or employees to originate FHA-insured loans. These agreements violate HUD/FHA requirements because they (1) state that the employee must supply all tools, equipment, and supplies, and/or (2) include provisions that the employee indemnify Apreva for any error or legal violation committed by the employee or employee's assistants. Further, most of these individuals were actually employees of other independent mortgage companies and not exclusively employed by Apreva. Loan applications completed by these individuals contained certifications to HUD that Apreva employees processed the applications. HUD/FHA considers the practice of mortgagees using ineligible branches and/or employees for the origination of insured loans a significant risk to the FHA insurance fund.

HUD Requirements Regarding Mortgagee Branch Offices and Employees HUD Handbook 4060.1 REV-1, *Mortgagee Approval Requirements*, contains the requirements regarding mortgagee branches and employees. The Handbook specifies that:

- Mortgagee employees must be exclusive to the mortgagee (Paragraph 2-14);
- The mortgagee must pay all branch office operating costs (Paragraph 2-17); and
- The mortgagee is responsible for the activities of its employees and its branches (Paragraphs 2-13 and 2-16).

Mortgagee Letter 00-15 (ML 00-15) provides additional guidance regarding mortgagee branches and employment agreements, stating:

"The Department has learned that some HUD/FHA approved mortgagees are engaged in the practice of taking on an existing, separate mortgage company or broker as a branch and allowing that separate entity to originate insured mortgages under the approved mortgagee's HUD Mortgagee Number. Some mortgagees refer to this arrangement as a 'net branch'. This, however, constitutes a prohibited net branch arrangement..."

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Apreva Submitted Loans Originated by Unauthorized Third Parties and Allowed Ineligible Branches to Originate Loans ML 00-15 also points out that employment agreements between a lender and its branches cannot contain indemnification provisions and makes it clear that HUD/FHA considers the practice of mortgagees using unauthorized branches and non-employees a significant risk to the FHA insurance fund.

Apreva entered into 31 Loan Officer Agreements with individuals that were not exclusive employees of Apreva, but who either owned or were employed by independent mortgage brokers. Under the terms of these agreements, the owner and its employees were authorized to originate FHA-insured single family loans as employees of Apreva.

The Loan Officer Agreements between Apreva and these individuals violate HUD/FHA branch office requirements since they contained provisions that required the employees to:

- supply all equipment, tools, and supplies required to perform the services called for under the agreement; and/or
- indemnify the employer for any losses resulting from (a) any misrepresentation (intentional, negligent, or otherwise), made by employee, (b) any fraud in the origination of any loans, whether or not as a result of any act or omission of the employee, or (c) any first payment defaults.

Compensation for these individuals was in the form of commissions based upon a split of loan origination and other fees between the employee and Apreva that are generated at loan closing. Our review found that loan applications submitted by these individuals contained addresses of loan officers that were not branch offices of Apreva. We also noted that some loan applications and other documents were faxed from independent mortgage broker offices, and that origination fees were sometimes paid directly to mortgage brokers and not to individual employees.

The following are examples of prohibited third party loan originations and prohibited net branch operations at Apreva.

- Columbia Northwest Mortgage Inc. is an independent mortgage broker that was never approved to originate FHA loans. However, the owner of the company as well as seven of its loan officers originated 58 FHA insured Apreva mortgages. We found loan origination documentation in the file that was faxed from Columbia Northwest's office. In addition, at least one of the loan origination fees was paid directly to Columbia Northwest
- Prior to Qualified Residential, Inc.'s approval as an FHA lender, its manager as well as two of its loan officers originated 18 FHA insured Apreva mortgages. Although the loan applications identify Apreva Funding as the loan officers' employer, the address shown is actually that of Qualified Residential's office. In addition, Qualified Residential's fax number was on some of the loan origination documents included in the file. We also noted at least one of the loan origination fees was paid directly to Qualified Residential, Inc.
- Pacific Mutual Mortgage and Apreva entered into branch manager employment agreements with Pacific Mutual's loan officers. Under these agreements Pacific Mutual originated 57 FHA loans from January 2001 to April 15, 2002 even though it was not an approved FHA lender or branch office.
- Sea Mist Industries originated 35 loans prior to becoming a HUD approved branch office in July 2002. Apreva hired the owner of Sea Mist Industries in October 2000. This individual was not exclusively employed by Apreva since he was the owner of Sea Mist Mortgage and also the Marketing Manager and loan originator for Prosperity Mortgage during that same period of time. Sea Mist's owner became branch manager of a HUD approved Apreva branch office, doing business as Sea Mist Mortgage, in July of 2002. One month after HUD approval of the branch office, the owner registered Sea Mist Mortgage as a Limited Liability Corporation in the State of Washington. Since Sea Mist Mortgage is a separate legal entity, it is not a true branch office of Apreva. As a separate legal entity, Sea Mist Mortgage originated 20 FHA loans with Apreva.

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Loan Files Contained Improper Certifications

Appendices D-01 through D-06, and E contain complete listings of the currently insured Apreva loans originated by unapproved third parties.

For every insured loan, lenders are required to submit a completed Uniform Residential Loan Application (URLA) signed and dated by all borrowers and the lender. The URLA includes an Addendum (form HUD-92900-A) with additional Lender's Certifications. The Lender's Certification in Part II.21.C of the Addendum states: "The information contained in the Uniform Residential Loan Application and this Addendum was obtained directly from the borrower by a *full-time employee of the undersigned lender or its duly authorized agent* and is true to the best of the lender's knowledge and belief." (emphasis added)

During the review of Apreva origination case files, we found numerous loans containing certifications signed as if the person taking the application was a full-time employee or authorized representative of Apreva. However these individuals were actually employees of ineligible branches or unauthorized third party loan originators. We also noted instances where someone other than the loan officer who processed the application made the certifications on their behalf. Further details of the case files that contained improper certifications can be found in Appendix F.

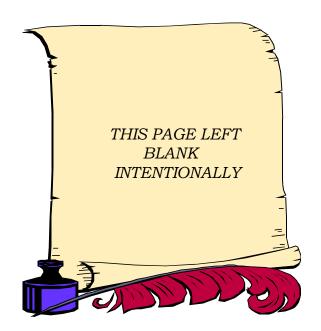
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Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, Chairman, Mortgagee Review Board:

- **2A.** Seek civil monetary penalties for each loan, identified in Appendices D-01 through D-06, and E, originated by illegal branches or employees.
- **2B.** Seek civil monetary penalties against the individuals making the improper certifications on the loan applications for each loan, identified in Appendix F, originated by the illegal branches or employees.
- **2C.** If HUD determines that Apreva, Inc. can maintain their approval as a non-supervised mortgagee (see Recommendation 1A), take appropriate monitoring measures to ensure that Apreva, Inc. discontinues the practice of submitting loans that are originated by ineligible or illegal branches and employees.

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Apreva Did Not Comply With HUD/FHA Quality Control Requirements

Apreva, Inc. did not fully comply with HUD/FHA quality control requirements. Specifically, Apreva did not (1) timely implement its Quality Control Plan (QCP) after receiving HUD/FHA approval, (2) always perform the required review of ten percent of its loans and loans defaulting within six months, (3) take prompt and effective corrective action after identifying numerous deficiencies, or (4) adequately supervise its loan correspondents. In addition, Apreva allowed loan correspondents to originate loans under Apreva's identification number. In our opinion, these deficiencies were due to Apreva's disregard of HUD/FHA's quality control requirements. Without a fully implemented quality control process, Apreva cannot evaluate the accuracy, validity, and completeness of its loan underwriting and origination operations.

Quality Control Requirements HUD Handbook 4060.1 REV-1, *Mortgagee Approval Handbook*, states the requirements mortgagees must meet in order to obtain and maintain approval to participate in HUD/FHA mortgage insurance programs. Paragraph 6-1 contains the overall requirement for the mortgagee's Quality Control Plan:

"As a condition of HUD-FHA approval, mortgagees. . . must have and maintain a Quality Control Plan for the origination and servicing of insured mortgages...The Quality Control Plan must be a prescribed function of the mortgagee's operations and assure that the mortgagee maintains compliance with HUD-FHA requirements and its own policies and procedures. It must be sufficient in scope to enable the mortgagee to evaluate the accuracy, validity and completeness of its loan origination and servicing operations. It must provide for independent evaluation of the significant information gathered for use in the mortgage credit decision-making process...The Quality Control Plan must enable the mortgagee to initiate immediate corrective action where discrepancies are found."

Paragraph 6-1(C)(1) requires originating mortgagees to perform quality control reviews on the lesser of either: (1) ten percent of all loans closed on a monthly basis, or (2) a random sample that provides a 95 percent confidence level with two percent precision. Paragraph 6-1(D)(3) further

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Apreva Did Not Timely Implement Its Quality Control Plan or Perform the Required Number of Loan Reviews requires each mortgagee to perform an analysis of all loans which go into default within the first six months.

Apreva's own Quality Control Plan states that "The minimum number of loans to be reviewed will be as follows: 10% of all FHA/VA loans originated by Qpoint" (Note: Qpoint is the former name of Apreva).

Although Apreva began operations as an FHA lender in July 1998, it did not perform any quality control reviews on FHA loans it originated and/or underwrote until 35 months after receiving FHA lender approval. It was not until June 2001 that Apreva hired an outside contractor to perform monthly quality control reviews.

Our review of Apreva's quality control reports for the period June 2001 through April 2003 found that, for its own loan originations, Apreva did not:

- Do quality control reviews on loans approved in December 2001, and the six-month period from August 2002 through January 2003.
- Include 10 percent of closed FHA loans in their quality control reviews for 8 out of the 16 months that quality control reviews were performed.
- Perform quality control reviews on any of the 80 Apreva-underwritten FHA loans defaulting within the first six months during this period.

Apreva's failure to consistently perform quality control reviews prevented it from effectively evaluating its lending processes, or identifying and correcting existing loan origination and underwriting deficiencies. Thus HUD/FHA had little assurance that Apreva's loans during this period were approved in conformance with the basic origination and underwriting requirements of FHA's single family insurance program.

Apreva Management Did Not Take Immediate and Effective Corrective Action After Identifying Serious Origination and Underwriting Deficiencies Paragraph 2-6D of HUD Handbook 4000.4 REV-1 CHG-2 requires direct endorsement lenders to maintain a quality control system incorporating desk and field reviews of a sample of mortgage loans underwritten for direct endorsement submission. According to the Handbook, "The review of the underwriting decisions and certifications would include compliance with HUD underwriting requirements, sufficiency of documentation and the soundness of underwriting judgments."

Paragraph 6-1A of HUD Handbook 4060.1 REV-1 further requires the lender's quality control plan to provide for periodic reports to senior management identifying areas of deficiencies disclosed by the quality control reviews. It also requires senior management to initiate prompt and effective control measures to eliminate the deficiencies identified in these reports.

Beginning with the first review in June 2001, Apreva's quality control review reports on loans originated by Apreva and its loan correspondents disclosed serious origination and underwriting deficiencies that resulted in the approval of high-risk insured loans. Between July 2001 and April 2003 the Quality Control reviewer identified 95 out of 115 FHA loans with significant origination and underwriting deficiencies.

The deficiencies included:

- Inadequate justification for approving loans to borrowers with excessive debt to income ratios:
- No justification showing that borrowers could afford the higher payments at the end of loan buydown periods;
- Incorrect borrower income calculations;
- Inadequate borrower income documentation;
- Incorrect debt calculations;
- Missing documentation;
- No explanation for derogatory credit; and

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Inadequate assets documentation.

Even though the reports repeatedly identified the same types of deficiencies, the total number of exceptions and average number of exceptions identified in the reports did not generally decrease as time progressed. We performed a limited review of 20 of these loans and found that 18 had major underwriting deficiencies and should never have been approved for FHA insurance. Appendix G to this report provides a summary of the loan underwriting deficiencies noted during our review. These deficiencies have caused potential losses to the FHA fund totaling \$1,633,412. Detailed results of our review will be provided under separate cover.

As previously noted, the quality control function was not performed from August 2002 through January 2003. During this period, Apreva hired the quality control reviewer as its Underwriting Manager to provide training and supervise the underwriting functions. The Underwriting Manager informed us that quality control reviews were temporarily discontinued because the same issues were repeatedly identified in the monthly reports and she had to use her time to devise and implement changes to address the recurring deficiencies. Nonetheless, the problems persisted and, as of April 2003, Quality Control reports continued to identify serious underwriting deficiencies for a majority of the files reviewed.

Although Apreva's hiring of a qualified Underwriting Manager could ultimately reduce the number of underwriting deficiencies reported, management has not taken sufficient action to address the deficiencies noted. For example, even though Apreva has replaced some of its underwriting staff, Apreva's top underwriter, hired in February 2000, continues to approve loans with major underwriting deficiencies. This underwriter has been allowed to continue approving insured loans even though the Underwriting Manager repeatedly informed top Apreva management of recurring underwriting deficiencies in the loans that this underwriter approved. (See Finding 1)

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Paragraph 6-1(G) of HUD Handbook 4060.1 REV-1 requires management to promptly distribute quality control results to all loan origination personnel. Employees should be provided with corrective instructions where patterns of deficiencies are identified. Likewise, Paragraph 6-1(D)(5) requires sponsor lenders to ensure that loan correspondents take actions to correct problems identified during the sponsor's quality control reviews.

Apreva did not provide quality control review results and corrective instructions to its loan officers, even though the reviews disclosed significant origination deficiencies. Further, while loans originated by its loan correspondents are included in Apreva's quality control reviews, the results of the reviews are not always passed on to the loan correspondents' management.

Apreva Did Not
Adequately Supervise Its
Loan Correspondents and
Allowed Loan
Correspondents to
Originate Loans Under
Apreva's Identification
Number

HUD/FHA relies on sponsor lenders to ensure the quality of loan originations by Loan Correspondents. According to Paragraph 3-4(A)(1) of HUD Handbook 4060.1 REV-1, "The Sponsor is responsible to the Department for the actions of its Loan Correspondent(s) in originating insured mortgages. A Sponsor is required to supervise and perform quality control reviews of its Loan Correspondent(s). This includes periodic visits and meetings to assure that the Loan Correspondent is in compliance with the Department's loan origination requirements and prudent lending practices."

Apreva personnel occasionally visit the offices of its loan correspondents. However the purpose of the visits is not to ensure compliance with HUD/FHA loan origination requirements, but to solicit business and discuss marketing strategies. A listing of Apreva's loan correspondents is provided in Appendix I.

Mortgagee Letter 94-56 allows approved Loan Correspondents to utilize the services of approved Sponsor lenders for processing FHA insured loans stating: "Under this option, the Loan Correspondent mortgagee must take the original application and conduct the face-to-face interview as required. The loan must close in the name of the Loan Correspondent. When requesting the FHA case number from the local HUD field office, the request must be made in the name of the Loan Correspondent, as is currently required..." It further states "It is HUD/FHA's

mission to promote homeownership while continuing to manage the level of risk to the FHA insurance fund and preserve the interests of FHA mortgagors. In order to meet these goals, the department believes it is imperative that HUD/FHA know with whom we are doing business."

Although Mortgagee Letter 96-12 eliminated the requirement that a loan must close in the name of the Loan Correspondent, it still requires that the request for the FHA case number be made in the name of the Loan Correspondent.

According to Mortgagee Letter 98-13, mortgagee identification numbers are for the exclusive use of the individual mortgagee and it is unlawful to use such numbers to access HUD computer systems without authorization.

Apreva's origination log contained 35 loans originated under Apreva's mortgagee identification number that were in fact originated by various Apreva correspondent lenders. See Appendix H for a listing of the active FHA loans.

In our opinion the deficiencies associated with Apreva's quality control plan and procedures stem from Apreva's disregard for HUD/FHA requirements. Under HUD's Single Family Direct Endorsement Program, the mortgage loan is underwritten and closed without prior HUD review or approval. Therefore, it is imperative that Apreva implement its quality control policies and procedures in accordance with HUD/FHA requirements. Without proper establishment of a quality control plan and procedures, Apreva is unable to ensure the accuracy, validity, and completeness of its loan origination and underwriting operations, thereby exposing HUD to an increased risk of default.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, Chairman, Mortgagee Review Board:

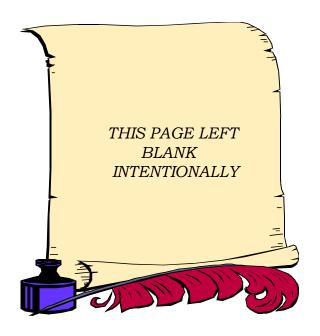
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- **3A.** Require Apreva to indemnify HUD/FHA against future losses on loans totaling \$1,633,412 identified in Appendices A and G of this report.
- **3B.** Impose civil monetary penalties on Apreva, as applicable, for the deficiencies described in this finding (see Appendices G, H and I).

If Apreva, Inc. is allowed to continue participating HUD's Single Family Mortgage Insurance Programs (See Recommendation 1A. in Finding One), we recommend that you require Apreva, Inc. to:

- **3C.** Fully establish and implement an adequate quality control process and related reviews.
- **3D.** Conduct periodic visits and meetings with its loan correspondents to ensure they are in compliance with HUD/FHA loan origination requirements.
- **3E.** Inform the loan correspondent of any origination deficiencies found during Apreva's quality control reviews of the loan correspondent's loans.

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Management Controls

Management controls include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls We determined the following management controls were relevant to our audit objectives:

- Program Operations. Policies and procedures that management has in place to reasonably ensure that the loan origination process is in compliance with the HUD/FHA program requirements, and that the objectives of the programs are being met.
- Validity and Reliability of Data. Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and used during the mortgage loan origination process.
- Compliance with Laws and Regulations. Policies and procedures that management has implemented to reasonably ensure that its loan origination process is carried out in accordance with applicable laws and regulations.

We assessed the relevant controls identified above.

It is a significant weakness if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet an organization's objectives.

Based on our review, we believe the following items are significant weaknesses:

- Apreva did not underwrite loans in accordance with all applicable HUD/FHA requirements, Findings 1 and 3.
 (Program Operations, Validity and Reliability of Data, and Compliance with Laws and Regulations)
- Apreva violated HUD/FHA requirements in the origination of FHA insured mortgages by unapproved

Significant Weaknesses

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branches and non-employees, Finding 2. ((Program Operations and Compliance with Laws and Regulations)

 Apreva did not fully comply with HUD/FHA quality control requirements, including timely resolution of deficiencies, Finding 3. ((Program Operations and Compliance with Laws and Regulations)

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Schedule of Questioned Costs and Funds Put to Better Use

Recommendation	Type of Qu	Funds Put	
Number	Ineligible 1/	Unsupported 2/	To Better Use 3/
1B.	\$ 814,284	\$ 552,199	\$ 1,234,310
3A.			\$ 1,633,412
Totals	\$ 814,284	\$ 552,199	\$ 2,867,722

<u>1</u>/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law, contract or Federal, State or local policy or regulations. The amount shown is for net claims. A net claim is the total claim paid by HUD less any proceeds from HUD's sale of the insured property.

2/ Unsupported costs are costs charged to a HUD-financed or HUD-Insured program or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures. The amount shown is for gross claims. A gross claim is the amount of the claim paid by HUD prior to any recovery from the sale of the property by HUD. At the time of the audit, HUD had not yet sold the properties.

<u>3</u>/ Funds put to better use are costs that will not be expended in the future if our recommendations are implemented, for example, costs not incurred, de-obligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

The table on the following pages shows a breakdown of the above schedule by the description of each individual category of questioned cost and costs put to better use.

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Recommendation 1B.

35 Loans With Significant Underwriting Deficiencies – See Appendix C for Details

FHA	Ineligible	Unsupported	Funds Put To Better Use
Case Number	(Net Claim)	(Gross Claim)	(Loan Amount)
431-3503033	\$42,487		
431-3515212			\$115,192
431-3551311	\$25,453		,
431-3559344	,		\$127,991
431-3581581	\$53,514		
431-3600832	\$29,247		
431-3633059	\$54,662		
431-3635825	\$35,450		
431-3684152	\$37,927		
431-3699469	\$29,036		
431-3703222		\$124,673	
431-3729577	\$54,279		
561-7182695		\$156,408	
561-7182716			\$87,087
561-7187129	\$19,830		
561-7189612	\$48,280		
561-7231738			\$151,488
561-7243033	\$32,744		
561-7280695	\$51,433		
561-7284327	\$33,983		
561-7285374	\$53,707		
561-7286022	\$46,147		
561-7309100			\$131,929
561-7321226			\$152,047
561-7324721	\$25,529		
561-7343562		\$131,429	
561-7355242			\$162,450
561-7365244		\$139,489	
561-7458291		\$200	\$168,388
561-7473527	\$19,681		
561-7525367	\$40,930		
561-7549790			\$137,738
569-0485961	\$35,569		
569-0522991	\$21,583		
569-0540546	\$22,813		
TOTALS 1B.	\$814,284	\$552,199	\$1,234,310

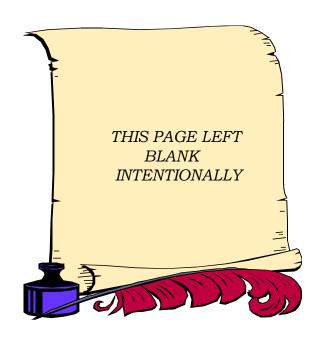
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Recommendation 3A.

11 Currently Insured FHA Loans Identified During Apreva's Quality Control Reviews with Significant Underwriting Deficiencies (See Appendix G for Details)

FHA Case Number	Ineligible (Net Claim)	Unsupported (Gross Claim)	Funds Put To Better Use (Loan Amount)
431-3625726			\$147,190
561-7475697			\$152,112
569-0532591			\$149,257
431-3719006			\$ 85,163
431-3731876			\$174,757
561-7498436			\$162,943
431-3659062			\$141,725
431-3747456			\$178,203
561-7540790			\$143,744
561-7714083			\$140,790
431-3880566			\$157,528
TOTALS 3A.			\$1,633,412

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Auditee Comments and OIG's Evaluation

Names, other than owners, have been blacked out in the auditee comments in order to ensure the privacy of Apreva employees, borrowers, and others. The numbers in the right hand margin represent the blacked out name(s) on the corresponding line. Identifying descriptions of these individuals can be found in the table following the auditee comments. See page 87.

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Auditee Comments

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JULY 14, 2004



VIA FEDERAL EXPRESS

Frank E. Baca
Regional Inspector General for Audit, 0AGA
U.S. Department of Housing and Urban Development
Office of the Inspector General
Northwest/Alaska Region 10
909 First Avenue
Suite 126
Seattle, Washington 98104-1000

Re: Apreva, Inc.

HUD OIG Draft Audit Report

Dear Mr. Baca:

Apreva, Inc. d/b/a Apreva Funding ("Apreva" or "Company") is in receipt of the Draft Audit Report ("Report"), dated May XX, 2004, from the U.S. Department of Housing and Urban Development ("HUD" or "Department") Office of the Inspector General ("OIG"). The Report is based on a review of Apreva initiated in March 2003, and it covers the period between January 1, 2001 and March 1, 2003.

The Report contains three findings, alleging underwriting deficiencies in 38 Federal Housing Administration ("FHA") insured mortgage loans, improper branch operations, and insufficient Quality Control, with recommendations to the Department for administrative action against Apreva. The Report states that the purpose of the OIG audit was to determine Apreva's compliance with HUD/FHA requirements. The Report, however, largely fails to identify specific statutes, regulations, or guidelines that support its conclusions. Moreover, while the OIG informed Apreva in April 2003, when it first visited the Company's offices, that the OIG review was initiated because of concerns regarding fraudulent activity, in fact, the OIG did not identify any fraud in Apreva's business activities or loan transactions.

As set forth below, this response: (I) summarizes Apreva's history and operations, including several changes that have occurred at the Company; and (II) addresses the individual findings in the Report. It contains information clarifying certain errors and misconceptions referenced throughout the Report, as well as responds to the OIG's specific allegations and

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recommendations. We appreciate the additional time afforded to Apreva to reply to the Report, as well as this opportunity to comment on the OIG's findings and recommendations.

I. <u>INTRODUCTION</u>

While Apreva responds below to the individual findings in the Report, it is crucial in this instance to recognize that the Company has undergone substantial corporate changes over the past few years and that, other than three loans cited in Finding 3, the practices and loan transactions identified in the Report all relate to activity prior to June 2002. The Report addresses Apreva's former policies and procedures that were in place during a time of tremendous growth for the Company, not Apreva's current practices. Furthermore, the Report suggests that Apreva was on notice of underwriting concerns but did not take any corrective action. The Report, however, fails to consider substantial changes that have occurred at the Company, including enhancements to its underwriting and Quality Control/compliance procedures and its excellent default/claim rates. The Report also contains several inaccuracies. After reviewing this response and supporting documentation, we hope the OIG will agree not only that Apreva has demonstrated a commitment to FHA compliance and dedication to its relationship with the Department, but that the recommendations in the Report are disproportionate to the alleged deficiencies.

A. APREVA, INC.

Comment 1

Apreva was incorporated as a small mortgage lender in Olympia, Washington on January 6, 1998. In June 2000, two of Apreva's original three owners agreed to sell their interest to a new co-owner, presently the Chief Executive Officer ("CEO"), who expanded the Company's wholesale business. In the fall of 2003, while maintaining an office in Olympia, Apreva relocated its headquarters to Bellevue, Washington. Apreva now operates in three states (i.e., Washington, California, and Oregon) through its home office and 11 branch offices, one of which is engaged only in conventional lending, and it employs 80 individuals.

Apreva received approval to participate in HUD's FHA mortgage insurance programs as a Direct Endorsement ("DE") lender in July 1998, and approximately one-third of the Company's business operations now consist of FHA lending. Apreva currently has 10 registered branch locations, sponsors 178 loan correspondents, is an authorized agent for seven principals, and is a principal for four authorized agents. Apreva does not service any FHA loans, but sells all FHA loans that it originates into the secondary market on a servicing-released basis. The Company's primary investors include, among others, Countrywide Home Loans, Inc., Wells Fargo, Washington Mutual, and CitiMortgage. Inc.

Auditee Comments

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As a sizeable lender committed to low-income and minority borrowers, who constitute approximately 15% of the Company's clientele, Apreva is dedicated to the FHA program and diligently educates and trains its employees on issues regarding FHA compliance. To this end, Apreva has made a number of changes to its corporate structure and FHA lending practices over the past few years. During its evaluation of Apreva, the OIG reviewed 49 loans, 46 of which were funded prior to June 2002. Between January 2001 and June 2002, like most of the mortgage industry, Apreva experienced tremendous growth. The industry was in the midst of a refinance boom, interest rates were lower than they had been in decades, and mortgage companies were facing difficulties in finding enough employees to handle their expanded business. The new co-owner and present CEO of Apreva had brought an expanded wholesale operation, which caused the Company's originations to grow from \$3 or \$4 million per month to \$15 million per month over a short period of time, and Apreva's retail operation simultaneously expanded within the Bellevue area. Like other lenders, Apreva's business grew rapidly and strained the Company's infrastructure. Due to growing pains experienced during this transition period, Apreva made a number of changes to its policies and procedures, including reducing the wholesale business and hiring new in-house counsel, in January 2003. As described below, Apreva also made a number of changes to its underwriting staff in an effort to improve underwriting performance and enhanced its Quality Control and compliance functions.

Having said that, please note that Apreva's FHA loan portfolio consists of quality originations and the Company does not pose a risk to the FHA Insurance Fund. The language in the Report suggests that Apreva routinely originates ineligible loans for FHA insurance endorsement and that the Company somehow poses a threat to the FHA. To the contrary, Apreva's default/claim rates evidence the quality of its loan originations. For example, Apreva had only 10 defaults in 2000, 35 in 2001, 11 in 2002, and three in 2003. Between January 2003 and May 2004, there are only three defaults. While the number increased to 35 in 2001, the increase resulted from the Company's tremendous growth at the time. For the two-year period ending May 31, 2004, Apreva originated 1,831 FHA loans. HUD's FHA Connection/Neighborhood Watch reflects only eight loans currently in default or claim (Exhibit A). Apreva originated 2,795 FHA loans during the OIG review period, only a handful of which are identified in the Report.

Comment 2

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The Neighborhood Watch report's indication that Apreva originated only 274 loans over the past two years is in error. Apreva's records indicate that the Company funded 1,831 FHA loans during that period.

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B. BUSINESS CHANGES

1. <u>Underwriting</u>

Over the past few years, and prior to the OIG review, Apreva has: (1) reevaluated and modified its underwriting policies and practices; (2) hired a corporate Underwriting Manager; (3) terminated underwriters; and (4) re-assigned underwriters to non-underwriting positions. Specifically, in June 2000, Apreva had a single underwriter, who was located in its Olympia office. In July 2000, in a move to expand its wholesale operations, the Company opened a wholesale office in Bellevue, Washington. The new staff included , an underwriter with approximately 20 years of experience, and , a funder who also acted as a back-up underwriter. In June 2001, Apreva hired experienced senior loan processor, as a junior underwriter for its Bellevue office. While employees and other underwriters in Bellevue may have consulted with Ms. because of her experience, she was not formally designated as an underwriting manager nor did she supervise underwriters in any other location. Michele Clayborn, the founder and one of the current owners of Apreva who had previously been employed in Quality Control by a local bank, supervised all of Apreva's administrative and "back-office" functions, including underwriting. Until November 2002, all of Apreva's underwriters, including reported to Ms. Clayborn in regard to underwriting matters. In November 2002, Apreva hired as its in-house corporate Quality Control Manager and Underwriting Manager. In April 2003, when Ms. began to underwrite loans, she ceased performing Quality Control and assumed the position of Underwriting Manager fulltime.

Comment 6

Comment 3

Comment 4

Comment 5

has proved to be an invaluable addition to Apreva. She has been a DE underwriter since 1985 and has substantial experience in the mortgage industry. Between 1983 and April 1989, Ms. was the Assistant Vice President of the Mortgage Lending Division at Central Evergreen Bank and then at First Community Bank in Lacey, Washington. In these positions, Ms. developed and implemented the government lending divisions and supervised the loan origination, processing, underwriting, secondary marketing, appraisal, and closing departments. Between April 1989 and June 1999, Ms. Senior Vice President of the Mortgage Lending Division at Heritage Bank in Olympia, Washington where she not only supervised the same types of activities as she had for her previous employers, but, among other things, was responsible for the development of all new residential lending products (including underwriting standards) and for the development and performance of training programs for origination, processing, closing and underwriting personnel. After working for a third-party consulting and Quality Control firm for three years and performing Quality Control in-house at Apreva, Ms. now supervises the Company's underwriting department and is responsible for developing and maintaining quality assurance standards for underwriting conventional and government loan programs,

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Ref to OIG Evaluation

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developing and implementing new loan programs, and developing and maintaining all ongoing training for loan processing and underwriting personnel.

On its own initiative, Apreva addressed concerns with underwriting both before was hired as Apreva's corporate Underwriting Manager. Of those underwriters who underwrote loans listed in Findings 1 and 3: and were reassigned to non-underwriting duties; was terminated for performance reasons on April 9, 2002, less than 120 days after her initial was counseled and monitored. Even before receiving poor hire: and from the HUD Santa Ana Homeownership Center in June 2003, ratings of Apreva had placed restrictions on Ms. underwriting activities until such time as she had attended training and demonstrated to Ms. consistent adherence to FHA underwriting guidelines. Furthermore, when performance warranted it, Apreva has reviewed, counseled and in some cases terminated other underwriters who were not involved in files included in this audit. Apreva now has five underwriters: in Olympia. and in Bellevue, and in Lake Forest.

In addition, Apreva made certain policy changes regarding its underwriting requirements and performance. For example, is required to review and approve all loan applications with credit scores below 580. Ms. also conducts internal FHA training sessions for the Company's staff and holds regular meetings with the underwriters to discuss areas of concern and any new applicable requirements or guidelines. Additionally, Apreva routinely reviews its default/claim rates for individual branches in FHA Connection/Neighborhood Watch. In those cases where high default/claim rates are identified, Apreva investigates the reasons for the high rates and takes corrective action, including termination of the branch office if necessary. Apreva's success in this regard is evidenced by its current default/claim rate. As previously noted, for the two-year period ending May 31, 2004, Apreva funded 1,831 FHA loans, and HUD's FHA Connection/Neighborhood Watch reflects only eight loans in default or claim.

Comment 2

Comment 7

2. **Quality Control and Compliance**

Comment 8

In addition to hiring an Underwriting Manager and modifying its underwriting policies and procedures, Apreva has made certain changes to its Quality Control and compliance practices. Between January 1998 and June 2001, Apreva performed Quality Control in-house. One of the Company's owners, Michele Clayborn, performed Quality Control reviews. Ms. Clayborn regularly reviewed Apreva's operations, as well as individual loan files, and discussed her findings with pertinent staff. Ms. Clayborn ensured that corrective action was taken when necessary, and she maintained records

Comment 9

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of the results of Quality Control reviews for at least a year, as required by the thencurrent Mortgagee Approval Handbook. See HUD Handbook 4060.1 REV-1, ¶ 6-3(F).

In June 2001, in an effort to tighten its Quality Control procedures, Apreva hired Compliance Services, Inc. ("CSI"), an independent third-party compliance firm, to perform Quality Control and compliance examinations of the Company (Exhibit B-1). Between June 2001 and November 2002, CSI performed Quality Control reviews of individual loan files, determined where additional training might be needed, and provided management reports explaining the results of its reviews.

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In June 2002, agreed to join Apreva as the Company's in-house Quality Control Manager and Underwriting Manager. Due to her prior commitments to existing CSI clients, however, she did not officially start until November 1, 2002. Between November 2002 and April 2003, Ms. performed Quality Control reviews and reported directly to Michele Clayborn. Due to certain business concerns that arose during Ms. first several months at Apreva, however, the Company fell two months behind in performing Quality Control reviews. For this reason, and in order to allow Ms. to underwrite loan files, Apreva re-assigned Ms. the Underwriting Manager full-time in April 2003, and it hired Cognasso Consulting, a third-party consulting firm, to perform Quality Control reviews of the Company (Exhibit B-2). Cognasso Consulting consistently reviews at least 10% of Apreva's monthly FHA loan originations. It selects the loans and provides written reports of its findings to , Michele Clayborn, and Dave Pederson, who then review the findings with personnel and ensure the implementation of corrective measures where necessary. While Apreva may have experienced some difficulties implementing timely Quality Control in the past, any such problems have been resolved. The Company adheres to a detailed Quality Control plan that complies with FHA requirements (Exhibit B-3), as well as ensures the performance of timely Quality Control reviews and takes responsibility for correcting any deficiencies identified in the reviews.

Comment 10

In addition to tightening its Quality Control standards, Apreva hired a new Compliance and Branch Administrator, in August 2001. Among other things, Ms. is responsible for coordinating and reviewing mortgage broker relationships, which include loan correspondents, and administering branch offices. For example, with respect to broker relations, Ms. receives broker approval packages and ensures that they contain all required information and documentation (e.g., corporate documents, state and federal licenses and registrations, credit documents, FHA Quality Control Plans and reports, MARI release forms, etc. . . .). Ms. reviews the items received and ensures that they are acceptable, as well as reviews brokers for various items on a monthly, bi-annual, and annual basis. With respect to branch operations, Ms. is responsible for, among other things, ensuring that all required employment and lease agreements are executed, all required information and

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Comment 11

Comment 12

documentation are obtained from new employees, branch office expenses are determined and submitted to the corporate accounting department, and branch offices are appropriately registered with HUD/FHA. When she first arrived at Apreva, Ms. reviewed the structure and operation of each FHA branch office to ensure the office was properly registered with HUD and operating in accordance with FHA guidelines. Over the next three years, Apreva terminated 28 loan officers, closed several branches, and adopted new employment agreements. We believe that Ms. employment, as well as Apreva's enhancements to underwriting and Quality Control, has benefited the Company's operations and contributed to its achievement of excellent default/claim rates over the past few years.

II. RESPONSE TO FINDINGS

The Report contains three findings with recommendations for administrative action by HUD. Contrary to the allegations in the Report, however, Apreva generally complied with FHA requirements in connection with the matters raised in the Report, and the OIG's recommendations are disproportionate to the alleged deficiencies. We address each finding in turn below.

A. FINDING 1 – APREVA COMPLIED WITH FHA UNDERWRITING REQUIREMENTS

In Finding 1, the Report alleges that Apreva approved FHA-insured single-family loans containing underwriting deficiencies. It alleges that the Chief Underwriter did not ensure that the loans were processed in accordance with HUD/FHA requirements and that Apreva's management did not implement corrective action after receiving notice of underwriting deficiencies. Specifically, Finding 1 alleges that, after Apreva hired a new Underwriting Manager in June 2000, who became the Chief Underwriter in November 2002.2 the percentage of poor ratings for mortgage credit analysis increased and the percentage of loans with good post-endorsement technical review ratings decreased. Finding 1 states that the Chief Underwriter continues to underwrite loans for Apreva, despite the fact that the HUD Santa Ana Homeownership Center issued a letter to Apreva in June 2003 citing the underwriter's poor performance, and that Apreva took no action to correct and prevent such underwriting problems. Finding 1 further alleges that, in 38 cases, Apreva did not follow all applicable HUD/FHA underwriting requirements in connection with qualifying ratios and compensating factors, income stability, source of funds, creditworthiness, property appraisals, and file discrepancies. The Report recommends that, as a result of the deficiencies identified in Finding 1, the Department

Comment 13

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Based on e-mail correspondence from the OIG, dated June 30, 2004, we understand that the OIG plans to change all references to this individual as the Underwriting Manager or Chief Underwriter in its final report to reflect that she was a Senior Underwriter.

Auditee Comments

Frank E. Baca July 14, 2004 Page 8

should terminate Apreva's FHA approval, impose sanctions against the Company's President, CEO and Chief Underwriter, impose civil money penalties, and require indemnification of the 38 loans.³

Comment 14

Contrary to the suggestion in Finding 1, Apreva has substantially complied with FHA underwriting requirements and its loans were eligible for FHA endorsement. The Company has continuously had controls in place to monitor underwriting performance, and the management implemented corrective measures to cure any noted deficiencies in underwriting matters. At all times relevant to this proceeding, either Michele Clayborn or Apreva's underwriting operations, and Ms. has provided ongoing FHA training for Company personnel. Moreover, many of the allegations in connection with the 38 files cited in Finding 1 are unsupported and/or involve subjective determinations, not objective requirements. Apreva's decisions to approve the loans were both reasonable and permissible in these cases.

1. <u>Apreva has Diligently Monitored Underwriting Performance nd</u> <u>Taken Corrective Action When Necessary</u>

Finding 1 alleges that Apreva permitted an underwriter to continue working in a supervisory position even after receiving notice of HUD's concerns with her underwriting performance and that the Company did not take corrective action to ensure adherence to FHA underwriting requirements. These allegations are at variance with the facts.

Comment 3

Initially, the allegations in Finding 1 reflect a misunderstanding of how Apreva's underwriting department was set up. The "Underwriting Manager" / "Chief Underwriter" mentioned in the Report refers to the serior of the Report refers to the serior underwriter in the Bellevue office in July 2000. While Ms. The serior underwriter in Bellevue, at no time was she an "Underwriting Manager" or "Chief Underwriter" and she at no time acted in a supervisory capacity over other underwriters or personnel. Michele Clayborn, one of Apreva's owners, oversaw all underwriting functions until November 2002, at which time Apreva hired

Comment 5

In addition, contrary to the suggestion in the Report, Apreva took corrective action to address deficiencies identified in underwriting performance. While Apreva hired Ms. in July 2000, it was not until three years later, in June 2003, that HUD first notified Apreva of any concerns with Ms. loans. Apreva promptly responded to HUD's concerns at that time. On June 10, 2003, HUD issued a "Feedback" or informational letter to Apreva advising the Company that Ms. had received an unacceptable number of poor ratings between January 1 and March 31, 2003 (Exhibit C-1). Specifically, the letter identified nine FHA loans that Ms.

Comment 7

Comment 15

Based on e-mail correspondence from the OIG, dated June 30, 2004, we understand that the OIG plans to drop all references to two of these 38 loans in its final report.

Comment 16

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underwritten. On August 15, 2003, Apreva furnished a written response to the Department's letter along with supporting documentation (**Exhibit C-2**). As detailed in that response, most of the findings in the cases cited against Ms. were technical in nature and did not affect the underlying loans' insurability. For example, in several instances where the letter alleged that documents were missing, the items were in Apreva's files but may not have been copied in the insuring packages. To the extent any documents were not included in the insuring packages, such an error was not committed by Ms.

Apreva not only responded to the Department's June 10th letter and rebutted many of the findings therein, but it implemented internal measures to ensure Ms. and other underwriters' adherence to FHA guidelines. With respect to Ms. Apreva placed restrictions on her underwriting activities. Ms. was required to attend in-house FHA training sessions with and to submit all applications falling outside certain parameters to Ms. for review prior to loan approval. Apreva also brought the matters raised in HUD's June 10th letter to the attention of the other underwriters and reviewed proper underwriting procedures with them. Since that time, Apreva's default/claim rates have improved substantially and there is no reason to question Ms. qualifications to engage in FHA underwriting activities. Apreva responded quickly to the concerns identified by the Department and acted appropriately under the circumstances.

Moreover, even before receiving HUD's June 10th letter regarding Ms. Apreva had hired to manage the underwriters, which included daily supervision and the provision of FHA training, as well as fired certain underwriters. In fact, Apreva terminated two of the six underwriters involved in the loans cited in Findings 1 and 3 and re-assigned one of the underwriters to a non-underwriting position prior to the OIG audit. Apreva takes its underwriting responsibilities seriously and at no time disregarded the importance of compliance with FHA underwriting requirements. The Report's findings in this regard should be withdrawn.

2. <u>Apreva Substantially Complied with FHA Requirements in the Cited Cases</u>

Comment 17

With respect to the 38 loans identified in Finding 1, the Report fails to provide specific information regarding all but three of the cited loans. In Appendix C, the Report includes a table of alleged underwriting deficiencies, but it does not provide any details regarding the purported violations in each case. The summary of the types of allegations noted in the table is insufficient to identify the OIG's concerns in particular files. The lack of specificity makes it impossible to address each individual

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loan separately, which therefore places Apreva at a disadvantage in defending the OIG's allegations.⁴

Having said that, please note that all 38 loans were funded prior to June 2002, before the Company terminated three underwriters and hired a new Underwriting Manager. In addition, a cursory review of the files suggests that the findings in the Report are largely incorrect. In many cases, it appears that, while the OIG may disagree with the underwriters' decisions, the decisions were permissible under FHA guidelines. In other cases, the Report fails to cite violations of any particular FHA requirements. In the three cases for which the Report provides detailed allegations, the allegations are at variance with the facts, do not constitute violations of HUD/FHA requirements, or do not involve material violations that would affect the underlying loans' insurability. For these reasons, the recommendations in the Report are disproportionate to the findings and we hereby request that the OIG reconsider them.

a. The Findings Involve Subjective Determinations

While the Department has set forth a myriad of rules and regulations to govern the underwriting of FHA loans, it has also granted authority to FHA-approved lenders to exercise discretion in making credit decisions based on the totality of the circumstances. For instance, while certain credit documents must be obtained, it is the underwriter's decision as to whether a particular borrower is creditworthy based on the borrower's overall pattern of credit behavior. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-3.5 The Department has acknowledged that "[u]nderwriting is more of an art than a science and requires the careful weighing of circumstances that affect the borrower's ability and willingness to make timely mortgage payments." Mortgagee Letter 00-24; see also Mortgagee Letter 95-07. Underwriting requires the subjective evaluation of information based on experience in determining whether a potential borrower is creditworthy, and an underwriter must carefully weigh all aspects of an individual's application. Were two underwriters to review the same file, one might approve a loan where the other would deny a loan. Each underwriter, however, may have complied with FHA requirements, and each one may have made a reasonable and prudent underwriting decision. Nevertheless, the OIG secondquesses Apreva's underwriting decisions in many of the cases cited in Finding 1. In these cases, while the OIG may disagree with the credit decisions, the decisions were reasonable in each instance.

On June 29, 2004, at the conclusion of Apreva's exit conference with the OIG, the OIG provided a 74-page supplement to the Report containing detailed allegations in each case cited in Finding 1. Given the length of the supplement and short time frame in which Apreva must reply to the Report, however, the OIG indicated that it does not expect Apreva to reply to the supplement at this time. This response therefore addresses only the matters raised in the Report.

While the Department has issued a new Mortgage Credit Analysis Handbook, 4155.1 REV-5, the new Handbook did not become effective until January 1, 2004. We therefore rely on the prior Handbook 4155.1 REV-4, CHG-1, and accompanying Mortgagee Letters throughout this response.

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For example, the Report alleges that, in 29 cases, there were high qualifying ratios with insufficient compensating factors. Appendix C of the Report references Paragraphs 2-12 and 2-13 of the Mortgage Credit Analysis Handbook, 4155.1 REV-4, CHG-1. As stated in Paragraph 2-12, lenders rely on a borrower's qualifying ratios to determine whether the borrower can be expected to meet his or her housing expenses. The Department established benchmark guidelines of 29% and 41% for a borrower's mortgage payment-to-income and total fixed payment-to-income ratios, respectively, and noted that greater latitude is permissible on the front-end ratio.

As explained in Paragraph 2-13, however, the Department permits an underwriter to rely on compensating factors to approve a loan to a borrower with qualifying ratios that exceed the benchmark quidelines of 29% and 41%. Under such circumstances, Paragraph 2-13 requires an underwriter to list compensating factors in the Remarks section of the Mortgage Credit Analysis Worksheet ("MCAW"), and it references several compensating factors that may be considered. Prior to issuance of the new Mortgage Credit Analysis Handbook (4155.1 REV-5), however, which was not effective at the time the subject loans were originated and closed, HUD did not dictate which compensating factors were acceptable, the number of compensating factors that must exist, or the extent to which the benchmark guidelines could be exceeded. HUD expressly delegated all such decisions to the mortgage lender and did not limit the acceptable compensating factors to any particular items. ⁶ The Department professed that the "FHA does not set an arbitrary percent by which ratios may be exceeded but rather FHA relies on the underwriter to judge the overall merits of the loan application and to determine what compensating factors apply and the extent to which those factors justify exceeding the ratios." Mortgagee Letter 00-24 (emphasis added); see also Mortgagee Letter 95-07. Thus, where a potential borrower's qualifying ratios are high, an underwriter must consider all relevant circumstances and exercise discretion in deciding whether compensating factors exist and whether to approve or reject a loan.

While FHA guidelines permit lenders to determine what specific facts constitute compensating factors, the Department enumerated several examples of compensating factors that it would accept, including, among others: (1) substantial cash reserves after closing; (2) a good credit history or conservative attitude towards the use of credit; (3) a minimal increase in housing expenses; (4) the potential for increased earnings; (5) the receipt of income not included in effective income; and (6) high credit bureau scores.

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The new Mortgage Credit Analysis Handbook, HUD Handbook 4155.1 REV-5, ¶ 2-13, specifies that the 10 compensating factors enumerated in the Handbook are the only compensating factors that will justify approval of a loan to a borrower with qualifying ratios that exceed the benchmark guidelines. This Handbook, however, did not become mandatory until January 1, 2004. HUD Handbook 4155.1 REV-4, CHG-1 was applicable at the time the subject loans were originated and closed. Apreva therefore had discretion to determine what compensating factors existed.

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Comment 18

See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 97-26. Notably, the Department does not define these factors. For instance, it does not explain what constitutes substantial cash reserves, what type of credit history is considered "good," what amount of increase in housing expenses is considered "minimal," or what credit bureau scores are deemed "high." Rather, it leaves such determinations to individual lenders. In addition, while FHA guidelines specifically identify the aforementioned, and other, compensating factors, the Department recognizes that "each loan is a separate and unique transaction and that there may be other factors that demonstrate the borrower's ability and willingness to make timely mortgage payments." Mortgagee Letter 95-07 (emphasis added). The Department's concern with respect to compensating factors, as expressed in the above-referenced Handbook provisions and Mortgagee Letters, is that lenders too often fail to address which compensating factors justify their approval of a particular mortgage. The guidelines therefore remind lenders of their responsibility to explain why they believe a mortgage is an acceptable risk. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 95-07.

Comment 19

In compliance with the aforementioned requirements, Apreva's underwriters considered the totality of the circumstances in each of the 29 cases cited in Finding 1 where qualifying ratios and compensating factors are questioned. In each case, the underwriter determined that compensating factors both existed and justified loan approval. While some of the compensating factors could have been better explained in the Remarks sections of the MCAWs, compensating factors were documented in the loan files. Given that HUD had not yet limited the acceptable compensating factors to those enumerated in the Handbook and had delegated authority to lenders to determine whether compensating factors exist and the extent to which the benchmark ratios may be exceeded, Apreva adhered to FHA requirements in these cases. While the Report questions Apreva's underwriting decisions, it fails to identify a violation of any particular FHA requirement(s) and merely expresses disagreement with Apreva's determination that compensating factors offset the higher ratios. It is evident from the files identified in the Report that Apreva properly exercised its discretion and complied with FHA requirements in the cited cases. The underwriters' decisions were both permissible and reasonable.

The subjective nature of the allegations in Finding 1 is not limited to those cases involving qualifying ratios and compensating factors. For example, in some cases the Report alleges that the underwriter did not consider the effects of payment shock. In these cases, however, the underwriters did consider the increases in housing payments and reasonably determined that the borrowers could handle the increases. Similarly, Finding 1 disputes income calculations in a number of cases. In many of these cases, however, while the OIG may have calculated income using a method different than the one employed by the underwriter, in each case, the underwriter's method was permissible. Finding 1 also alleges that borrowers had poor credit in a number of cases.

Comment 20

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Creditworthiness, however, is primarily a subjective determination based on an applicant's overall credit record that the Department has delegated to lenders. See HUD Handbook 4155.1 REV-4, CHG-1, \P 2-3. To the extent that the allegations in Finding 1 involve subjective underwriting decisions rather than compliance with specific documentation requirements, the allegations are misplaced and should not result in any penalties against Apreva.

b. The Findings Fail to Cite Violations of Particular FHA Requirements

Not only do many of the allegations in Finding 1 involve subjective determinations, but the Report includes findings that simply do not constitute violations of FHA requirements. For example, Appendix C of the Report alleges that, in some cases, Apreva did not provide adequate evidence of the borrower's gift from a downpayment assistance program ("DAP"). It cites Mortgagee Letter 00-28 for the proposition that evidence of a wire transfer from the non-profit to the closing agent must be included in the file when downpayment assistance is received. Mortgagee Letter 00-28, however, contains no such requirement. It neither references downpayment assistance nor mentions wire transfers. In fact, the first paragraph of Mortgagee Letter 00-28 expressly states that the Mortgagee Letter applies to "procedures for verifying the transfer of gift funds from private individual donors to homebuyers" (emphasis added). Thus, Mortgagee Letter 00-28 does not apply to DAPs. Moreover, Page 2-11 of the Department's Single-Family Reference Guide states that the transfer of downpayment assistance funds may be reflected as a transaction on the HUD-1 Settlement Statement ("HUD-1"). It states:

When gifts are provided by a nonprofit or municipality through a downpayment assistance program (DAP), the same basic rules regarding documentation of gifts apply. The lender must obtain evidence from the donor (agency) of the amount of funds being provided, as well as evidence that no repayment by the borrower is required. Evidence of the actual transfer of funds can be shown as a transaction on the HUD-1. Costs for processing a DAP may not be included as part of the borrower's cash investment, but may be included in secondary financing.

http://www.hud.gov:80/offices/hsg/sfh/ref/sfhp2-11.cfm (emphasis added). Apreva complied with these requirements in the cases cited in Finding 1. The files contain gift letters evidencing the amount of funds being provided and that no repayment by the borrower is required, and the transfers of funds are shown as transactions on the HUD-

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1s. Thus, the allegations in these cases are unsupported and should be withdrawn from the final Report.

c. Apreva Complied with FHA Requirements and/or the Borrowers Qualified for FHA Loans in the Three Cases Detailed in Finding 1

While the Report fails to provide any detailed information for most of the cases cited in Finding 1, it does specify the alleged deficiencies in three sample cases: (1)

— FHA Case No. 431-3581581; (2)

— FHA Case No. 561-7286022.

Significantly, the allegations in these cases are at variance with the facts, do not constitute violations of HUD/FHA requirements, and/or do not affect the underlying loan's insurability. We are confident that, similar to these files, the remaining 35 files cited in Finding 1 were also eligible for FHA insurance endorsement. We address each file in turn below.

- FHA Case No. 431-3581581

Comment 22

In the case, Finding 1 alleges that Apreva approved a loan with qualifying ratios of 46.14% and 46.79% without documentation of significant compensating factors to justify approval of the loan. Finding 1 further alleges that the underwriter understated the ratios because the borrower's income and liabilities were not properly evaluated, failed to properly analyze the borrowers' funds, and failed to ensure that the source of DAP funds was adequately verified and documented.

With respect to the qualifying ratios and compensating factors, although compensating factors were not detailed on the MCAW, and while Apreva has reminded underwriting personnel of their obligations in this regard, there were significant compensating factors documented in the file that justified approval of the loan. Specifically, the borrower had substantial cash reserves after closing of \$1,800, thereby demonstrating an ability to accumulate savings, and there was only a minimal increase in housing expenses of \$197 (Exhibit D-1). The borrower also had only \$35 in monthly debt (Exhibit D-2), which demonstrated a conservative attitude towards the use of credit. Notably, the Department has expressly recognized all of these items as significant compensating factors that would justify approval of a loan to a borrower with qualifying ratios that exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13.

With respect to the borrower's income and liabilities, Apreva recognizes that the income was overstated by \$348.29 and that the liabilities were understated by \$25, such that the correct qualifying ratios were 54.5% and 56.3%. The borrower, however,

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still would have qualified for FHA financing. In addition to the compensating factors noted above, the borrower received about \$400 in bonus and overtime income (Exhibit D-3), which was noted in the Remarks section of the MCAW (Exhibit D-1). This additional income would offset the errors regarding the borrower's income and liabilities and constitute additional income not included in effective income but directly affecting the borrower's ability to repay the mortgage. The Department considers such income to be a significant compensating factor that would have justified loan approval. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13.

With respect to analysis of the borrower's funds, we are uncertain of the OIG's allegations. While the Report states that the funds were not analyzed properly, absent greater specification of the alleged deficiency, we cannot respond meaningfully to this finding.

Comment 21

Finally, with respect to the DAP funds from The AmeriDream Charity, Inc., contrary to the suggestion in the Report, the file contained all required documentation. Specifically, the file contained a Seller Enrollment Form, Gift Letter, and Downpayment Gift Program Application (Exhibit D-4), and the closing agent certified receipt of the funds on the HUD-1 (Exhibit D-5). While the OIG believes evidence of the wire transfer from the DAP provider to the closing agent should have been obtained, in fact, such evidence is not required in FHA transactions. As previously noted, Page 2-11 of HUD's Single Family Reference Guide requires three items in verifying DAP funds: (1) evidence from the donor of the amount of the gift; (2) evidence that no repayment from the borrower is required; and (3) evidence of the transfer of funds, which "can be shown as a transaction on the HUD-1." http://www.hud.gov:80/offices/hsg/sfh/ref/sfhp2-**11.cfm**. Apreva complied with these requirements in the case. The Gift Letter evidenced the amount of funds being provided and that repayment was not required, and the transfer was shown as a transaction on the HUD-1. No further documentation was required.

- FHA Case No. 561-7187129

Comment 23

In the case, Finding 1 alleges that Apreva approved a loan with a back-end ratio of 43.11% with no documentation of compensating factors to justify loan approval. In addition, Finding 1 alleges that there was inadequate verification of sufficient funds to close and that there was no evidence of the borrower's ability to make the mortgage payments because the borrower was unable to accumulate savings and faced a \$633 increase in housing costs.

ii.

Contrary to the allegations in Finding 1, there were significant compensating factors and sufficient funds to close in this case, and the underwriter properly analyzed the borrower's ability and willingness to make housing payments. With respect to the

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qualifying ratios, while the back-end ratio exceeded the benchmark guideline, the borrower had \$400 in cash reserves (Exhibit E-1), a good credit history for the past 24 months with no delinquent accounts, which was stated in the Remarks section of the MCAW, and high credit bureau scores of 652, 630 and 648 (Exhibit E-2). The Department has expressly recognized cash reserves, good credit, and high credit bureau scores as significant compensating factors that would justify loan approval for a borrower with qualifying ratios that exceed 29% and 41%. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 97-26. In addition, the credit report reflected timely housing payments for the past 26 months, and FHA guidelines provide that, where a borrower has made timely housing and other payments for the past 12 to 24 months, there is little reason to question the borrower's ability to continue to do so despite having ratios that exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13. With respect to the funds to close, the borrower needed \$1,394 to close the loan on January 30, 2001 (Exhibit E-3). The borrower's bank statement reflected a balance of \$1,254.98 on the day of closing (Exhibit E-4). The remaining \$139 would have come from cash accumulated from regular employment earnings. Moreover, there is no reason to believe that funds to close were derived from anyone other than the borrower. Finally, with the respect to the borrower's ability and willingness to repay the mortgage, contrary to the suggestion in the Report, there was no reason to reject the borrower's application merely because she did not have a history of accumulating savings, especially given the credit report's reflection of stellar housing payments for the past 26 months (Exhibit E-2). Apreva complied with FHA requirements in this case and made a prudent underwriting decision.

Comment 24

iii. – FHA Case No. 561-7286022

Comment25

In the and and case, Finding 1 alleges that Apreva did not properly evaluate the borrowers' ability to repay the mortgage. It states that the loan was approved with a front-end ratio of 33.25%, a \$1,021 increase in housing costs, a lack of savings ability, and poor credit history. Finding 1 further alleges that the underwriter understated the qualifying ratios because the borrower's income was not properly evaluated, failed to properly analyze the borrowers' assets and credit, and failed to ensure that DAP funds were adequately verified and documented. Contrary to these allegations, the

With respect to the qualifying ratios, while we recognize that compensating factors should have been noted on the MCAW, and while we have counseled Company employees in this regard, there were significant compensating factors documented in the file to justify approval of the loan. Initially, please note that HUD has expressly stated that greater latitude is permissible on the mortgage payment-to-income ratio than on the total fixed payment-to-income ratio, which was only 38.02% in this case (Exhibit

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F-1). See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-12(A). In addition, several significant compensating factors were present. For instance, the borrowers had made timely housing payments for the past 30 months and had only \$204 in monthly debt (Exhibit F-2), thereby demonstrating a conservative attitude towards the use of credit. The borrowers also had \$1,000 in cash reserves and the underwriter used only disability income to qualify the borrower even though his actual income would be higher (Exhibit F-1). The Department has expressly recognized such factors as significant compensating factors that would justify loan approval for a borrower with qualifying ratios that exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13.

With respect to the borrowers' ability and willingness to make timely housing payments, contrary to the suggestion in the Report, there was no reason to reject the borrowers' application merely because they did not have a history of accumulating savings. This is especially true in this case given the credit report's reflection of stellar housing payments for the past 30 months (Exhibit F-2).

With respect to the borrowers' credit, the underwriter reasonably determined that the borrowers were creditworthy. The borrowers' credit report reflected no derogatory items in the past year, except one immediately before the co-borrower graduated from school and obtained employment (Exhibit F-2). While the credit report did reflect a few small collections in the past in connection with medical bills, the borrowers provided acceptable letters of explanation indicating that the borrower had suffered a heart attack and lost a finger, which necessitated emergency medical care and resulted in confusion regarding insurance coverage (Exhibit F-3). The borrowers also received a good alternative credit reference (Exhibit F-4) and had made timely housing payments for 30 months (Exhibit F-2).

With respect to the borrowers' income and liabilities, based on the file documentation, it appears that these items were properly calculated and that the qualifying ratios were accurately determined. Thus, absent additional information, we cannot respond meaningfully to the findings in this regard.

Comment 21

Finally, with respect to the DAP funds from Nehemiah, contrary to the suggestion in the Report, the file contained all required documentation. Specifically, the file contained The Nehemiah Program Participating Home Agreement, the Gift Letter, an Online process form and confirmation of the DAP approval and wiring of funds (Exhibit F-5). The closing agent also certified receipt of the funds on the HUD-1 (Exhibit F-6). While we understand that the OIG believes evidence of the wire transfer from the DAP provider to the closing agent should have been obtained, such evidence is not required in FHA transactions. Again, Page 2-11 of HUD's Single Family Reference Guide expressly states that, when DAP funds are used, the lender must obtain evidence of the

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amount provided and that no repayment is required, and "[e]vidence of the actual transfer of funds can be shown as a transaction on the HUD-1." http://www.hud.gov:80/offices/hsg/sfh/ref/sfhp2-11.cfm. Apreva complied with these requirements in the case. The Gift Letter evidenced the amount of funds being provided and that repayment was not required, and the transfer was shown as a transaction on the HUD-1. No further documentation was required.

d. The Recommendations in the Report are Disproportionate to the Alleged Violations

Based on allegations that there were underwriting deficiencies in 38 cases and the incorrect notion that Apreva did not take corrective action after learning of deficiencies in one of its underwriters' loans, the OIG recommends that HUD not only require indemnifications from and impose civil money penalties against Apreva, but that HUD terminate Apreva's FHA approval and impose sanctions against the Company's President, CEO, and aforementioned underwriter. As detailed above, however, the OIG's impression that Apreva did not respond to underwriting concerns is misplaced. The Company in fact restricted the identified underwriter's activities and implemented numerous corrective actions that have resulted in significantly improved default/claim rates. Thus, while indemnifications and/or civil money penalties might be appropriate in connection with any loans where the OIG can demonstrate underwriting violations and/or that the borrowers were ineligible for FHA financing, neither termination of the Company's FHA approval nor sanctions against individuals are appropriate in this instance. Such measures typically are invoked where fraud or misrepresentation are present, not in situations where the only allegations involve poor underwriting decisions. These recommendations are grossly disproportionate to the alleged violations in Finding 1 and, we hope you will agree, should be removed.

B. FINDING 2 – APREVA OPERATES LEGITIMATE BRANCH OFFICES

In Finding 2, the Report alleges that Apreva allowed ineligible branches and non-employees to originate FHA-insured loans. It alleges that the Company entered into 31 Loan Officer Employment Agreements with individuals who were not exclusive employees of Apreva but who either owned or were employed by independent mortgage brokers, though loan applications completed by these individuals contained certifications that Apreva employees processed the applications. Finding 2 further alleges that the Loan Officer Employment Agreements were contrary to HUD/FHA requirements because they stated that employees would supply their own tools, equipment and supplies, required employees to indemnify Apreva for any losses resulting from misrepresentation by the employee, fraud in the origination of any loans and first payment defaults, and allowed employees to broker loans to other mortgagees. Finding 2 further alleges that loan applications submitted by loan officers contained

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addresses that were not branch offices of Apreva and were faxed from independent mortgage broker offices, and that origination fees were paid directly to mortgage brokers rather than to individual employees on two occasions. Finally, Finding 2 alleges that, in some instances, someone other than the loan officer who processed the application made the certification on the application on the loan officer's behalf. The OIG recommends that the Department require Apreva to indemnify HUD in connection with 29 loans and seek civil money penalties in connection with 332 loans.

Comment 28

Contrary to the allegations in the Report, <u>Apreva at no time allowed ineligible branches or non-employees to originate FHA loans for the Company.</u> During the OIG review period, Apreva conducted FHA lending through eight offices, its home office in Bellevue and seven branch offices located throughout Washington and Oregon. While Apreva recognizes that certain mistakes were made in connection with these offices, namely with respect to the exclusivity of employment, <u>all loans were originated by employees of the Company</u>. Furthermore, please note that any mistakes that may have occurred regarding the exclusivity of employment resulted from Apreva's misunderstanding of certain FHA guidelines, not from an attempt to circumvent applicable requirements.

Comment 29

As explained above, prior to June 2000, Apreva operated a small business through its headquarters in Olympia, Washington. In June 2000, when the Company's ownership was reorganized, Apreva became a primarily wholesale business headquartered in Bellevue and its volume increased significantly from approximately \$3 or \$4 million to \$15 million per month. During this time of rapid growth, Apreva also began to develop new retail business in the Bellevue area. As the new ownership previously had been involved almost exclusively in wholesale operations, it faced new challenges in developing the retail business. Among those challenges was the proper administration of branch offices. As you know, the entire lending industry had been confused regarding what types of branch operations were acceptable to the Department, and it was not until May of that year, through Mortgagee Letter 00-15, that HUD finally provided clarification. The concept of "net branching," however, had already mushroomed in the conventional market and been carried over to the FHA arena by numerous lenders who misunderstood FHA requirements. This was certainly the case in early 2000 when the branches at issue in Finding 2 were created. We hope the OIG will consider these facts, as well as Apreva's current compliance with FHA rules and regulations, in determining what, if any, action is appropriate in this instance.

Comment 31

Comment 30

Moreover, one-half of the loan officers referenced in Finding 2 were exclusive to Apreva, and any problems identified in Finding 2 neither resulted in loan-level deficiencies nor rendered Apreva's borrowers ineligible for FHA financing. In addition, Apreva has modified its business practices and its current branch office operations comply with HUD/FHA requirements. In fact, prior to receiving the Report. Apreva

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voluntarily terminated all of the branch offices that existed during the OIG review period, other than the Olympia office that originally served as the Company's headquarters, and Apreva has terminated the employment of all but four loan officers whose loans are cited in Finding 2.

1. Apreva Has Always Paid Branch Operating Expenses

Comment 33

Contrary to the suggestion in Finding 2, Apreva has paid the operating expenses of its branch offices since the Company's inception. We understand and appreciate that FHA lenders must be responsible for paying the operating expenses of their branch and satellite offices. See HUD Handbook 4060.1, REV-1, ¶ 2-17; Mortgagee Letter 00-15. Accordingly, the Company bears accounting and other administrative costs associated with its offices as business expenses.

As you may know, after establishing a branch office, a lender typically will collect the revenue from the branch, pay the branch expenses, and then pay certain employees the remaining revenue as a commission. Mortgagee Letter 00-15 expressly permits this form of accounting. To this end, lenders often create a profit and loss account for each office within their corporate accounts. While the mortgagee will realize all income from the office and bear all office expenses as they are incurred, it will credit and debit income and expenses to and from the office account that are attributable to that office and determine any net compensation due employees. The Department has stated that such an arrangement essentially is an alternative compensation program that is acceptable to HUD. See Mortgagee Letter 00-15.

As permitted by the Department, Apreva employs this type of accounting system in connection with its branch offices. It establishes an operating account for each branch within its corporate account, the corporate office is responsible for accounting and disbursement of all funds for the operation of each branch, and only corporate officers have signatory authority on the branch operating accounts. Neither Branch Managers nor loan officers are signatories to the accounts, and Apreva credits and debits items to the accounts as appropriate. Apreva has paid and continues to pay the bills for its branch offices. It has entered into a written lease or sublease agreement for office space used by each of its office locations, vendor contracts are in the Company's name, the corporate office monitors the income and expenses of each branch, and Apreva pays operating expenses from the branch operating accounts. For example, at Apreva's expense, the corporate office:

 pays all branch office expenses from the branch operating accounts, including, among other things:

o rent,

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- employee wages and bonuses and related benefits and other costs (<u>e.g.</u>, unemployment, workers compensation, insurance, advertising, etc. . . .),
- photocopy and facsimile expenses,
- o telephone services,
- o overrides,
- o office supplies,
- o computer hardware and software,
- o equipment rental and repair,
- o document preparation,
- o education,
- o janitorial services,
- o electrical and gas services,
- hazard and liability insurance,
- taxes,
- unreimbursed costs of appraisals, credit reports, flood certification fees, tax fees, wire fees, recording fees, processing, automated underwriting costs, submission fees, postclosing fees, and insuring fees,
- federal and state branch license or registration fees,
- loan delivery fees,
- o lock set-off fees or non-delivery fees or fines,
- o FICA matching fees, and

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- o accounting costs;
- maintains and renews any and all licenses, permits and authorizations pursuant to federal, state and local laws, ordinances and regulations necessary for branch operations;
- maintains insurance covering branch employees;
- provides branch loan processing software;
- provides branch loan processing and Quality Control reviews;
- provides branches with state and federal forms; and
- maintains all monthly accounting and bookkeeping records.

The corporate accounting department receives invoices for processing and payment, and all checks are drawn on Apreva's operating account and signed by a corporate officer. Apreva's Cash Disbursements Journal details vendor expenses for each branch that the Company pays. If there is a loss suffered by a branch in any given month, Apreva, not the Branch Manager, is responsible for covering the loss. Moreover, all employees working in each branch are W-2 employees of Apreva and receive payroll checks in Apreva's name. They are subject to Apreva's supervision and control and are included in the Company's Quality Control reviews.

In addition, ensures the proper establishment of new branch offices. Whenever Apreva establishes a new office, each new loan officer must complete a New Hire Retail Loan Officer Approval Checklist (Exhibit G-1), and the Branch Manager must complete a form providing information on any employees who will be joining Apreva at the branch office (Exhibit G-2), a Branch Business Plan providing information about projected loan origination volume and performance and projected branch income and expenses (Exhibit G-3), and a Branch Operating Budget outlining initial capital expenditures and estimated fixed monthly expenses (Exhibit G-4). Ms. ensures that appropriate employee, Branch Manager, and lease or sublease agreements are executed, and she furnishes the Branch Operating Budget to Apreva's corporate accounting department to alert the accounting personnel to the expenses that Apreva must pay for the branch.

With respect to the language in the Loan Officer Employment Agreement requiring employees to supply equipment, tools and supplies, the agreement provided that: "Employee shall supply all equipment, tools and supplies required to perform the services called for under this Agreement. This includes, but [is] not limited to.

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automobile transportation, cellular phone, home phone, faxes, supplies, and home See Exhibit G-5 (emphasis added). As indicated by the aforementioned phrase, the language in the agreement was intended to cover personal supplies that loan officers may desire but that are not essential to the operation of the mortgage lending business, including cellular telephone usage and home office equipment. It was not intended to cover typical expenses for which a mortgagee must pay, such as office rent, utilities, telephones, furniture, computers, photocopier machines, facsimile machines, and other common office items. We are unaware of any FHA prohibition against an employee paying for additional items that are unnecessary for operating the business but that the employee desires to have. While the Loan Officer Employment Agreement could have been more specific in this regard, as detailed above, Apreva has always paid the operating expenses of its branches. Moreover, please note that Apreva has modified its Loan Officer and Branch Manager Employment Agreements to clarify that the Company will furnish all necessary equipment and supplies and pay for all operating expenses (Exhibit G-6).

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With respect to the language in the Loan Officer Employment Agreement requiring that employees indemnify Apreva against fraud or misrepresentation in the origination of loans and first payment defaults, this type of indemnification is permissible. Apreva understands and respects the prohibition in Mortgagee Letter 00-15 against certain types of indemnification by Branch Managers or other employees. The prohibition, however, states that an employment agreement may not "require the 'employee' (branch) to indemnify the HUD/FHA approved mortgagee if it incurs damages from any apparent, express, or implied agency representation by or through the 'employee's' (branch's) actions." Significantly, the referenced indemnification provision in Apreva's Loan Officer Employment Agreement did not require this type of indemnification. In contrast, it required indemnification for damages resulting from the employee's violation of the agreement, fraud or misrepresentation in the origination of loans, and first payment defaults (Exhibit G-5). Mortgagee Letter 00-15 does not prohibit this type of indemnification.

Moreover, we understand that the prohibition against indemnification in Mortgagee Letter 00-15 was aimed at ensuring that mortgagees pay for operating expenses and assume responsibility for harm caused to third parties resulting from the actions of the mortgagee's employees. We understand that HUD does not object to a mortgagee's requirement that employees indemnify it for their commission of fraud/misrepresentation or violation of employment agreements, which, as previously noted, were the types of conduct covered by the indemnification clause at issue in the Report. In fact, we understand that the Department's Lender Approval and Recertification Division has acknowledged that a mortgagee may require a Branch Manager, loan officer, or branch office to pay for costs incurred in connection with repurchases due to the origination of loans that are fraudulent, contain material

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misrepresentations, or result in early payment defaults. This was precisely the nature of the indemnification provision at issue in this case. Apreva pays the operating expenses of its branches and assumes responsibility for any harm caused to third parties resulting from the actions of its employees. The cited indemnification provision in the Loan Officer Employment Agreement was narrow and complied with FHA requirements.

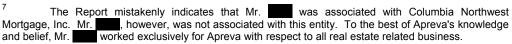
2. <u>All Loans Were Originated by Employees of Apreva and</u> FHA Loans Were Made Only to Qualified Borrowers

Finding 2 alleges that Apreva allowed non-employees to originate FHA loans, loan officers were not exclusively employed by Apreva insofar as they owned or were employed by independent mortgage brokers, and loan documents therefore contained the addresses of and/or were faxed from locations not associated with Apreva. Finding 2 further alleges that Apreva permitted loan officers to broker loans to other mortgagees. Contrary to these allegations, all loans were originated by employees of Apreva and loan officers were not permitted to broker loans independently of Apreva.

Finding 2 of the Report cites loans originated by 32 loan officers, all of whom were full- or part-time employees of Apreva. To the best of Apreva's knowledge and belief, the following 16 of these loan officers worked exclusively for the Company:

Comment 35





The Report mistakenly indicates that David Pederson was associated with Columbia Northwest Mortgage, Inc. Mr. Pederson, however, is not associated with this entity. He is an owner and the CEO of Apreva, and he works exclusively for the Company.

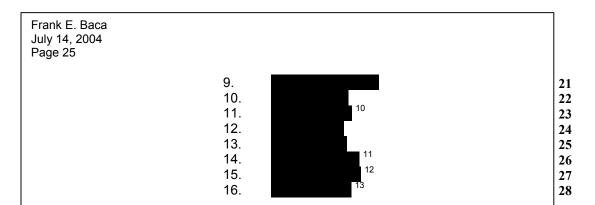
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The Report mistakenly indicates that Martin was associated with Columbia Northwest Mortgage, Inc. Mr. however, was not associated with this entity. To the best of Apreva's knowledge and belief, Mr. worked exclusively for Apreva with respect to all real estate related business.

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We are unsure of the basis for the allegation that these 16 loan officers were not exclusive to the Company. We note, however, that the Report reflects certain misunderstandings with respect to loan officers who worked at Pacific Mutual Mortgage and Sea Mist Industries. Moreover, while some of the loan officers referenced in Finding 2 did not work exclusively for Apreva, this deficiency resulted from Apreva's misunderstanding of FHA requirements during a time when the entire lending industry was confused regarding branch office requirements, the subject loan officers no longer work for the Company, and only qualified borrowers received FHA loans.

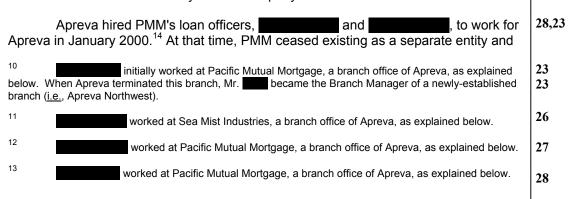
Comment 36

a. Pacific Mutual Mortgage and Sea Mist Industries

Comment 31

Pacific Mutual Mortgage ("PMM") and Sea Mist Industries ("SMI") were branch offices of Apreva. It appears that any confusion regarding these offices may have resulted from Apreva's delay in registering them with HUD/FHA until after they had begun operations. The delayed registrations were in error, and Apreva has since hired a Compliance and Branch Administrator to ensure that such errors do not recur in the future. Nevertheless, PMM and SMI were legitimate branch offices of Apreva and their loan officers worked exclusively for the Company.

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became a branch office of Apreva. Because the PMM loan officers wanted to continue to use the name PMM and operate from the same location as they had in the past, Apreva established PMM as a d/b/a of the Company and registered it as such with the State of Washington in January 2000 (Exhibit G-7). The loan officers became exclusive employees of Apreva and entered into an employment agreement pursuant to which they pledged to work only for the Company. The agreement provided:

Employee shall devote his/her entire productive time, ability and attention to the business of Employer during the term of this agreement. Employee shall not directly or indirectly render any services of a business, commercial or professional nature to any other person or organization, whether for compensation of otherwise, without Employer's prior written consent.

See Exhibit G-8.

Not only did the PMM loan officers work exclusively for Apreva, but the Company assumed responsibility for all off PMM's operating expenses. Apreva maintained a branch operating account for PMM and was responsible for all accounting and funds disbursement for the branch. The loan officers' employment agreement expressly provided that the Company would pay the operating expenses (Exhibit G-8). For example, PMM was located in office space rented from REMAX Four Seasons on a month-to-month basis. Apreva paid the rent directly to the landlord, as well as all other operating expenses for PMM, including employee salaries. For instance, enclosed please find:

- copies of Apreva's bank account statements from February and October 2002 for the PMM branch operating account;
- a copy of Apreva's cash disbursements journal from March 2001 reflecting the Company's direct payment of expenses;

Comment 38 Comment 39

The PMM branch was closed on March 17, 2003, at which time Apreva terminated its relationship with who reclaimed the name PMM, and became the Branch Manager of a newly-established branch office of Apreva (i.e., Apreva Northwest).

Because Apreva is a federally regulated institution, it is exempt from registration requirements in the State of Washington. Nevertheless, Apreva registered PMM as a d/b/a prior to learning that it was exempt from such requirements.

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- a copy of a check drawn on the branch operating account and signed by Michele Clayborn to pay for appraisals on PMM originations;
- a copy of a rent check from Apreva directly to the landlord; and
- copies of telephone service invoices and a check from Apreva directly to the service provider.

See Exhibit G-9. These items evidence that Apreva paid PMM's operating expenses and took responsibility for the branch.

Furthermore, contrary to the suggestion in Finding 2, neither the PMM loan officers nor any other employees of Apreva were permitted to broker loans to other lenders. Apreva itself acted as a broker in some cases such that loan officers brokered loans on Apreva's behalf to approved lenders, with any broker payments being made directly to Apreva, but employees were not permitted to broker loans independently of Apreva. It appears that the OIG's concern may have arisen from an addendum to the employment agreement stating Apreva's expectation that "60% of the origination will be banked with Apreva, Inc." (Exhibit G-8). Please note, however, that this provision was intended to require branches to have at least 60% of their originations funded by Apreva; the remaining 40% could be brokered out by Apreva, but not by the employees independently.

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In addition, while we recognize that SMI was not registered as a branch with HUD until July 2002, at which time Apreva registered it as a d/b/a under the name Sea Mist Mortgage, it was a legitimate office. Worked exclusively for the Company, and Apreva paid all operating expenses. Furthermore, the Report states that, while Apreva registered Sea Mist Mortgage as a d/b/a of the Company, Mr. subsequently registered an entity entitled Sea Mist Mortgage LLC in the State of Washington. Apreva, however, neither knew nor should have known of such registration. We also understand that Mr. created this limited liability company

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We understand that after Mr. left Prosperity, one employee remained and operated the entity as a contract processing firm full-time. Payments to Prosperity for contract processing were made by Apreva from escrow in individual transactions.

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for tax purposes and that the entity has been dormant since its creation and has not engaged in any business activities. In any event, Sea Mist Mortgage LLC and Apreva d/b/a Sea Mist Mortgage are two distinct entities. Mr. did not register the Apreva branch with the State of Washington, but rather used the same name to register an entirely different entity of which Apreva had no knowledge and which has been dormant since its creation. Additionally, the fact that Mr. wowned another company does not suggest that he did not work exclusively for Apreva. He was the owner of a dormant limited liability company, not an employee of an active entity.

Moreover, even though Apreva had intended to register PMM and SMI as

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branch offices of Apreva at the outset, both offices functioned as legitimate satellite offices up until the time they were registered. As you know, the Department permits the operation of a satellite office so long as certain requirements are met. A satellite office

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must be located within the HUD field office jurisdiction of a registered branch, be in a location conducive to mortgage lending operations, be clearly identified to the public and separate and apart from any other entity, be staffed by employees, have no direct contact with HUD, be included in the mortgagee's Quality Control reviews, and have operating expenses paid by the mortgagee. See Mortgagee Letter 94-39. Both PMM and SMI satisfied these requirements. PMM was located in the same HUD field office jurisdiction as the Company's Olympia office, was situated in a business office conducive to lending operations, was clearly identified to the public and separate and apart from any other entity, was staffed by exclusive employees of Apreva, was included in the Company's Quality Control reviews, and submitted its operating

Comment 43

Comment 44

HUD field office jurisdiction as the Company's registered Bellevue office and was assigned to the Bellevue office. While Mr. worked from his home, he did not meet with customers there. Mr. was exclusive to Apreva and his loans were included in the Company's Quality Control reviews. Thus, SMI was a permissible satellite office up until the time it became a registered branch.

expenses to corporate for payment. Thus, <u>PMM was a permissible satellite office up</u> until the time it became a registered branch. Similarly, SMI was located in the same

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Finally, Apreva understands and appreciates the Department's concern that some FHA-approved mortgagees may allow non-approved entities to originate FHA loans using their HUD identification numbers. The Department expressed this concern in Mortgagee Letter 00-15, where it indicated that the FHA branch office requirements are based on HUD's concern that some HUD/FHA approved mortgagees have taken on existing, separate mortgage companies/brokers as branches and allowed those separate entities to originate insured mortgages under the approved mortgagee's HUD identification number, thereby creating a "clear separation" between the approved mortgagee and its branches. These concerns, however, do not exist in this case. Both PMM and SMI were fully integrated into Apreva. Unlike situations where individual employees are responsible for paying operating expenses for their own offices, thereby

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Comment 46

raising the concern that such individuals/offices are separate and distinct from the FHA-approved entity, PMM and SMI were never responsible for paying their own operating expenses and employees of both offices were exclusive W-2 employees of the Company. Neither PMM nor SMI was a separate entity, and there was no separation between them and Apreva. The arrangements were consistent with the Department's goals underlying the FHA mortgagee approval and employment requirements.

b. Only Qualified Borrowers Received FHA Loans and the Referenced Loan Officers No Longer Work for Apreva

While 16 of the loan officers referenced in the Report worked exclusively for Apreva, the remaining loan officers, including those associated with Columbia Northwest Mortgage, Inc. and Qualified Residential, Inc., did not work exclusively for the Company. This deficiency arose because of a misunderstanding of FHA requirements, not from any attempt to circumvent HUD rules or regulations. During the time period covered by the OIG review, Apreva misunderstood the FHA requirement that employees work exclusively for the FHA lender to mean that employees may work for only one FHA lender at a time, not that employees may work for only one real estate related entity at a time. In other words, Apreva believed that so long as an employee did not work for any other FHA-approved entity at the same time he or she worked for Apreva, FHA requirements would be satisfied. For this reason, certain employees were associated with independent mortgage brokers that were not FHA-approved and originated conventional loans for those entities.¹⁷ Note, however, that such brokers were not branch offices of Apreva. The Company hired loan officers associated with these brokers as W-2 employees, such that only employees of the Company originated FHA loans.

Comment 47

Comment 32

Furthermore, as explained above, Apreva began its operation as a small lender in Olympia. In June 2000, the Company reorganized and developed a primarily wholesale business headquartered in Bellevue. It experienced rapid growth and began to develop a sizeable retail business in the Bellevue area. Significantly, these changes occurred at a time when the industry was just receiving clarification from HUD regarding branch office administration. For several years, the mortgage lending industry had been confused regarding what types of branch office operations are acceptable to the Department. It was not until May of 2000 that the Department provided clarification on the matter. While we appreciate that Apreva misunderstood the FHA requirement regarding exclusivity, we hope the OIG will consider the industry's circumstances, as well as Apreva's current compliance with FHA rules and regulations, in determining an appropriate recommendation in this instance.

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It is for this reason that certain documentation may have been faxed from such entities to Apreva. In the two cases where a loan origination fee allegedly was paid to the other entity rather than to the individual, such payment was in error and should not have occurred.

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Having said that, Apreva now appreciates that its prior understanding of the exclusivity requirement was incorrect and that all employees of Apreva must work exclusively for the Company during normal business hours and may not work for any other real estate related entity, regardless of whether such entity is FHA-approved. For this reason, even prior to receiving the Report, Apreva terminated six of the seven FHA branches that existed during the review period, maintaining only the Olympia branch that previously served as the Company's headquarters. Apreva also terminated its use of the Loan Officer and Branch Manager Employment Agreements in force at the time (Exhibit G-5), as well as most of the individuals employed under such agreements. See, e.g., Exhibit G-10. Specifically, Apreva terminated 28 of the 32 loan officers referenced in Finding 2 between December 31, 2001 and May 17, 2004, 18 of whom were terminated before the OIG audit was initiated in March 2003. Four of the 32 loan officers continue to work for the Company, but all four have always been exclusive to Apreva. Note also that the last loan originated by any of the terminated employees was through Columbia Northwest Mortgage, Inc., and it was funded in April 2002. More than two years have passed since any of the cited loans were funded.

Although some loan officers did not work exclusively for Apreva during the OIG review period, and while Apreva has since modified its employee agreements and business practices to ensure that all employees work exclusively for the Company, we do not believe that any former deficiency in connection with this matter warrants the indemnification of the cited loans. All loan officers originating loans for Apreva were W-2 employees of the Company, were subject to Apreva's supervision and control, and were required to attend Company meetings and scheduled events. Finding 2 does not suggest that any of the loans contain deficiencies affecting the borrowers' eligibility for FHA financing and there have been no allegations of fraud, misrepresentation, or faulty origination or underwriting. The only allegation in Finding 2 is that the loan originators were not exclusive to Apreva, which is a technical violation unrelated to the loan transactions themselves. The Company at no time intentionally circumvented HUD requirements and only qualified borrowers received FHA mortgage loans. Thus, we hope you will agree that indemnifications are inappropriate.

3. <u>Apreva's Current Branch Office Operations Comply with</u> <u>FHA Requirements</u>

Although Apreva misunderstood the exclusivity requirement in the past, and while Apreva has always paid the operating expenses of its branch offices, the Company modified its branch office operations prior to receiving this Report. As noted

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Three loans cited in Finding 2 are also cited in Finding 1. The allegations in Finding 1, however, are unrelated to the matters raised in Finding 2. They involve purported underwriting deficiencies and bear no relationship to whether the loan was originated by an exclusive employee.

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above, Apreva closed six of the seven FHA branch offices that existed during the OIG review period and terminated 28 of the 32 loan officers. Apreva currently conducts FHA lending from its home office in Bellevue and 10 branch offices. In compliance with FHA requirements, each branch office: is registered with HUD/FHA; is situated in a location conducive to performing the mortgage lending business; is separate and apart from other entities; is clearly identified to the public through adequate signage; has separate telephone lines; is staffed by employees of the Company who are required to work exclusively for Apreva; has a designated Branch Manager who is located on-site; is subject to Apreva's supervision and control; and is included in the Company's Quality Control reviews. All branches are fully integrated into the Company. They are not separate entities, and Apreva takes responsibility for the actions of branch office personnel.

In addition, Apreva has adopted new Loan Officer and Branch Manager Employment Agreements (Exhibit G-6). The new Loan Officer Employment Agreement clarifies that Apreva "will supply at its expense all equipment, supplies and facilities that are deemed appropriate by Employer in order for Employee to perform the services called for under this Agreement. Employer is responsible for all operating expenses of its mortgage lending business." It further provides that an employee:

shall not, directly or indirectly, either as an employee, employer, consultant, agent, principal, partner, stockholder, corporate officer, director, or in any other individual or representative capacity, engage or participate in any mortgage business or real estate related fields or in any business that is in competition in any manner whatsoever with the business of Employer. Employee must conduct only the affairs of Employer during normal business hours.

Similarly, the new Branch Manager Employment Agreement provides that:

Apreva, through its corporate office located in Bellevue Washington shall assume responsibility for accounting and disbursement of all funds for the operation of Branch Manager's branch. . . . Apreva is the sole authorized entity to transact any banking transaction on behalf of the corporation, Apreva, Inc. and the branch. Branch Manager has no authority to open or control any bank account on behalf of Apreva, Inc. or in any way relating to the operations of the branch. . . . All invoices to be paid shall be in the name of Apreva, Inc. and signed by an authorized individual from the corporate office. . . . Branch Manager understands that his/her

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employment with Apreva, Inc. is an exclusive relationship and Branch Manager will not be employed either by a traditional relationship with W-2 withholding or through Independent Contractor status and 1099 reporting, by any other person or entity.

In sum, Apreva has paid the operating expenses of its branch offices since the Company's inception. While a handful of loan officers did not work exclusively for the Company for a limited period of time, any deficiency in connection with this matter constituted at worst harmless error. The loans that such employees originated were subject to Apreva's Quality Control and the borrowers qualified for FHA financing. There is no allegation that the loans themselves are somehow deficient because of the matters raised in Finding 2. Moreover, Apreva has terminated the branch offices and loan officers involved in the cited cases and adopted new Loan Officer and Branch Manager Employment Agreements to clarify the Company's practices.

C. FINDING 3 – APREVA IS COMMITTED TO QUALITY CONTROL

In Finding 3, the Report alleges that Apreva did not timely implement its Quality Control Plan after receiving HUD/FHA approval. Specifically, it alleges that Apreva began operations as an FHA lender in July 1998, but that it did not perform any Quality Control reviews until June 2001, when it hired an outside contractor. Finding 3 further alleges that, with respect to reviews conducted for the period June 2001 through April 2003, Apreva did not perform Quality Control reviews of loans approved in December 2001 or August 2002 through January 2003, did not include 10% of closed loans in reviews for eight of the 16 months reviewed, and did not perform reviews of early payment defaults. In addition, Finding 3 notes that Apreva's Quality Control reports repeatedly identified the same types of deficiencies and that the average number of exceptions identified in the reports did not generally decrease as time progressed. It alleges that, while Apreva has replaced some of its underwriting staff, its top underwriter continues to approve loans and the Company has not taken sufficient action to address noted deficiencies. Finding 3 also alleges that Apreva did not provide Quality Control review results and corrective instructions to loan officers or visit loan correspondents' offices for Quality Control purposes and provide results of reviews to the management of loan correspondents. Finding 3 alleges that Apreva permitted loan correspondents to originate 35 loans using the Company's mortgagee identification number and that it improperly closed brokered loans in its own name. Finding 3 ultimately alleges deficiencies in 18 files, seven of which are included in Finding 1. The Report recommends that the Department require Apreva to indemnify HUD in connection with 15 loans and impose civil money penalties in connection with 35 loans.

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Contrary to the allegations in Finding 3, Apreva has performed Quality Control since its inception, as well as taken corrective action where necessary and adequately supervised its loan correspondents. Moreover, many of the allegations in individual cases involve subjective determinations, not objective requirements, and we believe that Apreva substantially complied with FHA requirements in these cases. We address these matters below.

1. Apreva Timely Implemented Quality Control

With respect to the timely implementation of Quality Control, contrary to the suggestion in the Report, Apreva has performed Quality Control since its inception. As explained above, between July 1998 and June 2001, Apreva performed Quality Control in-house. One of the Company's owners, Michele Clayborn, who had previously been employed in Quality Control by a local bank, performed the Quality Control reviews. Ms. Clayborn regularly examined Apreva's policies and procedures, as well as 10% of closed loan files, and reviewed her findings with pertinent staff. As required, Ms. Clayborn also maintained written reports containing the results of her Quality Control reviews. While Apreva has located copies of the reports for March, April and May 2001, we have been unable to locate any other reports prepared by Ms. Clayborn. Nevertheless, please note that Apreva was no longer required to maintain copies of such reports at the time of the OIG audit in March 2003. FHA guidelines required the Company to maintain records of the results of Quality Control reviews for only one year. See HUD Handbook 4060.1 REV-1, ¶ 6-3(F). Thus, Apreva was no longer required to maintain any of Ms. Clayborn's records, which concluded in May 2001, nearly two years later when the OIG began its audit in 2003. Ms. Clayborn, however, did perform Quality Control and ensure that corrective action was taken when necessary.

Comment 50

In June 2001, Michele Clayborn ceased performing Quality Control and Apreva hired CSI for this purpose (Exhibit B-1). As previously noted, between June 2001 and November 2002, CSI performed Quality Control reviews of closed loan files, determined where additional training might be needed, and provided management reports explaining the results of its reviews. Apreva's management discussed the results with Company staff and implemented corrective measures when necessary. In June 2002, agreed to join Apreva as the Company's in-house Quality Control Manager and Underwriting Manager, and she began work for the Company on November 1, 2002. Between November 2002 and April 2003, Ms. performed Quality Control reviews and reported directly to Michele Clayborn. The results of Ms. s reviews were distributed to senior management and appropriate corrective action was taken in response to her findings. In April 2003, Apreva re-assigned Ms. as the Underwriting Manager full-time and hired Cognasso Consulting to perform Quality Control reviews (Exhibit B-2). Cognasso Consulting now reviews 10% of Apreva's closed loan files and issues reports directly to

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Pederson, and Michele Clayborn. Apreva's management reviews all Quality Control findings, discusses them with loan production staff, and ensures that any necessary corrective actions are taken.

Although CSI and performed Quality Control reviews for Apreva between June 2001 and April 2003, the Report alleges that no Quality Control was performed in December 2001 or August 2002 through January 2003, that the reviews did not include 10% of closed loans in some months, and that early payment defaults were not included. Contrary to the allegations in the Report, Apreva performed Quality Control reviews in December 2001 and August 2002 through January 2003. We have located the Quality Control reports for December 2001 and August through November 2002. While formal Quality Control reports were not prepared in December 2002 and January 2003 due to a backlog at the Company, please note that Quality Control reviews were performed. In fact, reviewed close to 50% of Apreva's closed loans during those months. She met with the underwriters to discuss her findings and worked with them to ensure improvements in certain areas, wrote memorandums to both underwriters and management regarding her findings, and met with management officials to discuss the status of her reviews and corrective actions being implemented by the underwriters. While we recognize that formal reports should have been prepared during those two months, Quality Control reviews were in fact performed.

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Comment 53

With respect to the Quality Control sampling sizes, we cannot respond meaningfully to the allegation that reviews did not include 10% of closed loans without more information regarding the months and reviews of concern. Apreva believes that it reviewed 10% of closed loans each month. It is possible, however, that in determining the percentage to review, Apreva may have rounded down rather than up. For example, if Apreva closed 12 loans one month, it may have reviewed one loan by rounding 10% of 12, or 1.2, down to one. In such cases, we do not believe it would be fair to characterize the review as less than 10%.

Finally, with respect to the review of early payment defaults, we recognize that such loans have not been included in the Company's Quality Control reviews. This omission was an oversight and did not result from any attempt to circumvent FHA requirements. Please note that Apreva has modified its policies and procedures to ensure the timely review of all early payment defaults. Like other loans selected for Quality Control reviews, early payment defaults will be submitted for review to Cognasso Consulting, which provides written reports of its findings directly to senior management. While Apreva may have experienced some difficulties implementing Quality Control in the past, any such problems have been resolved and will not recur.

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2. Apreva Has Taken Corrective Action

Comment 54

The Report's assertion that Apreva did not take corrective action to address noted deficiencies in its origination or underwriting performance is incorrect. Between late 2000 and 2003, prior to the OIG audit, Apreva made a number of changes to its business operations in response to the Company's rapid growth and deficiencies identified during Quality Control reviews. As previously noted, these changes included:

- reducing Apreva's wholesale business;
- hiring new in-house counsel;
- closing six branch offices;
- terminating 28 loan officers;
- hiring a full-time Underwriting Manager with substantial industry experience;
- terminating two of the six underwriters involved in the loans cited in Findings 1 and 3, and re-assigning one of the underwriters to a non-underwriting position;
- placing restrictions on one underwriter's activities;
- holding regular underwriter meetings;
- re-evaluating and modifying underwriting policies, including requiring that the Underwriting Manager review all loan applications falling outside certain parameters;
- conducting FHA training sessions;
- outsourcing Quality Control reviews to an independent third party;
- hiring a new Compliance and Branch Administrator;
- adopting new Loan Officer and Branch Manager Employment Agreements; and
- establishing new procedures for the creation of new branch offices.

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Comment 2

Significantly, Apreva's default/claim rates evidence that its corrective actions were successful. As previously noted, Apreva had only 10 defaults in 2000, 35 in 2001, 11 in 2002, and three in 2003. Between January 2003 and May 2004, there are only three defaults. For the two-year period ending May 31, 2004, Apreva funded 1,831 FHA loans, and HUD's FHA Connection/Neighborhood Watch reflects only eight loans currently in default or claim. Apreva's FHA loan portfolio consists of quality loan originations and the Company does not pose a risk to the FHA Insurance Fund. The language in the Report suggests that Apreva routinely originates ineligible loans for FHA insurance endorsement and ignores deficiencies identified by Quality Control reviewers and HUD. Such allegations, however, are unsupported. Apreva has responded promptly to concerns identified, and its default/claim rates evidence the quality of its loan originations.

3. Apreva Adequately Supervises Loan Correspondents

Apreva sponsors a number of loan correspondents, all of which the Company routinely supervises and includes in its Quality Control reviews. Contrary to the suggestion in the Report, however, Apreva is neither required to furnish the results of its reviews to the management of loan correspondents nor to close loans in the name of loan correspondents.

Comment 55

With respect to the results of Quality Control reviews, FHA guidelines provide that a sponsor must perform reviews on loans purchased from each of its loan correspondents, not that it must share the results of such reviews with the loan correspondents' management. The requirement to furnish results to management is triggered only where a loan correspondent enters into a contractual arrangement with the sponsor to perform Quality Control. See HUD Handbook 4060.1 REV-1, ¶ 6-1(D)(5). No such contractual arrangements existed in this instance.

Comment 56

With respect to the closing of loans, while the Mortgagee Approval Handbook, published in September 1993, originally provided that all loans originated by a loan correspondent must be closed in the name of the loan correspondent, see HUD Handbook 4060.1 REV-1, ¶ 3-4(A)(2), HUD subsequently revised this rule. In February of 1996, HUD issued Mortgagee Letter 96-12, which provides:

Elimination of the requirement that loans must be closed in the name of the Loan Correspondent.

As of March 4, 1996 (the effective date of this Letter), approved Sponsors and their FHA approved Loan Correspondents will have the option of closing a

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mortgage loan to be insured by FHA in either the name of the Sponsor or in the name of the Loan Correspondent. . . . This change is effective for all loans with a closing date on or after March 4, 1996. When requesting the Mortgage Insurance Certificate (MIC), the mortgagee will be required to specify whether the MIC is to be prepared in the name of the Originator (Loan Correspondent) or in the name of the Sponsor. The name on the MIC must be the name which appears on the closing documents (HUD-1, Mortgage, Deed, etc.)

Comment 57

Thus, Apreva properly closed loans originated by loan correspondents in the Company's name.

Comment 58

Finally, with respect to the allegation that loan correspondents originated 35 loans using Apreva's mortgagee identification number, any deficiency in connection with this matter was inadvertent and constituted at worst harmless error. Apreva understands and appreciates that a loan correspondent must originate loans using its own mortgagee identification number. It is Apreva's policy and procedure in every brokered transaction to ensure that the loan correspondent uses its own identification number and not the Company's number. In those cases referenced in Finding 3, however, it appears that the loan correspondents' error was not detected. Please note that this deficiency occurred only in a handful of cases and does not reflect Company practice. Apreva has brought the matter to the attention of its employees and will ensure that such mistakes do not recur. Having said that, Finding 3 makes no allegation of any deficiencies in the cited loans themselves, and all of the borrowers qualified for FHA financing.

Comment 59

Moreover, please note that, since hiring as the new Compliance and Branch Administrator, Apreva's loan correspondent relationships have undergone substantial change. As explained above, Ms. , among other things, reviews loan correspondents for various items on a monthly, bi-annual, and annual basis. Specifically, she reviews approved loan correspondents on a monthly basis to ensure their licenses are in good standing, their financial statements are acceptable, and they are satisfying certain Veterans Administration and FHA requirements. She ensures that each loan correspondent is using its own FHA identification number to originate loans and verifies each loan correspondent's name and address. Account Executives also visit loan correspondents' offices at least twice each year and complete Quality Control review checklists, copies of which are furnished to both Ms. and the Underwriting Manager (Exhibit H). On an annual basis, Ms. retrieves a MARI report on each loan correspondent, reviews each loan correspondent's Neighborhood Watch data,

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investigates and reviews any claims against each loan correspondent, and audits each loan correspondent file to ensure it contains updated financial statements, licenses, contact information, and Quality Control reports. Apreva is careful to ensure that loan correspondents satisfy all applicable FHA requirements and demonstrate quality loan origination performance.

4. Apreva Properly Originated the Cited Files

Comment 60

Finally, with respect to the 18 individual files cited in Finding 3, similar to Finding 1, the Report fails to provide specific information regarding the alleged deficiencies in each case. It notes that seven of the files are included in Finding 1, and, in Appendix G, it includes a table of alleged underwriting deficiencies in the remaining 11 cases. The Report, however, does not provide any details regarding the purported deficiencies in each case. Having said that, on June 10, 2004, the OIG provided a 19-page supplement ("Supplement") to the Report containing detailed allegations in each of the 11 cases cited in Appendix G. Given the length of the Supplement and short time frame in which Apreva must reply to the Report, the OIG indicated that it does not expect Apreva to reply to the Supplement at this time. Nevertheless, because we believe that many of the allegations are misplaced, Apreva would like to take this opportunity to respond to the findings in the Supplement.

Initially, please note that all but 3 of the loans referenced in Finding 3 were

funded prior to June 2002, before the Company implemented significant operational changes. Moreover, the majority of the OIG's findings in these cases were derived from Apreva's own Quality Control reviews of the files. Notably, Quality Control reviews are aimed not only at ensuring compliance with technical requirements, but also at striving to achieve what a company views as best practices. Quality Control findings, including those in the cases cited in Finding 3, do not necessarily reflect violations of FHA requirements; rather, they often highlight issues on which a company would prefer that underwriters take a different approach. In fact, during the OIG's on-site review, the OIG informed that the Company's Quality Control findings in many cases were too restrictive. Moreover, our review of the files in question suggests that the findings in the Report generally do not allege violations of FHA requirements. While the OIG may disagree with the underwriters' decisions in these cases, and while Apreva's Quality Control reviews may suggest that more conservative underwriting would have been preferred, the underwriting decisions were generally permissible under FHA guidelines and the borrowers qualified for FHA loans. As explained above in reply to Finding 1, the Department has recognized that underwriting is more of an art than a science and that careful weighing of the circumstances is necessary in any given transaction to determine whether FHA financing is appropriate. See Mortgagee Letters 00-24 and 95-07. While two underwriters may make different underwriting decisions in a particular case, both

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decisions may be reasonable and appropriate under FHA guidelines. We address each of the 11 files cited in Appendix G in turn below.

– FHA Case No. 431-3625276¹⁹

In the case, the Supplement alleges that Apreva neither documented the stability of income nor clarified and/or documented file discrepancies. Specifically, the Supplement alleges that Apreva included child support income that was not adequately supported. It states that the underwriter used \$776 per month for qualification purposes but that the loan file did not include documentation required by Loan Prospector ("LP"). It states that LP required a court order stipulating child support payments and verification of the remaining term, and evidence of three months' payments. The Supplement alleges, however, that the file did not contain a copy of the court order and that the check amounts for the past three months varied from \$221 to \$1,175. It alleges that without this income, the borrower's qualifying ratios would increase from 38.26% / 48.91% to 48.10% / 61.49% without any compensating factors. Finally, the Supplement alleges that Apreva improperly included gift funds in the calculation of cash reserves insofar as the loan was entered into LP with \$2,014 in cash reserves when the only assets were those reflected in the aift letter for \$6.500.

With respect to the child support income, LP did not require a copy of the court order. The LP Document Checklist and Feedback Certificate required the following: "Most recent 3 months bank statements or cancelled checks or court payment record and evidence of 3 years continuance if using income to qualify." See Exhibit I-1 (emphasis added). Thus, Apreva was required to obtain two types of evidence to document the child support income: (1) three months' bank statements, cancelled checks, or a court payment record; and (2) evidence that the income would continue for three years. In compliance with these requirements, the loan file contained three months' checks (Exhibit I-2) and evidence the income would continue for at least three years, including a Stipulated Judgment of Dissolution of Marriage indicating that the borrower's children were only seven, eight and ten at the time of loan origination (Exhibit I-3) and a certification of the same information by the borrower on her loan application (Exhibit I-4). These items satisfied the LP requirements. Moreover, the amount of child support was not overstated. The file contained four checks for \$1,175.52, \$221, \$677.55, and \$801.96, which covered a three-month period and average over \$950 per month. Thus, the underwriter's use of \$776 was conservative. Apreva adhered to the LP directives in this case and properly considered the borrower's child support income.

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The Supplement references FHA Case No. 431-3625276. Please note, however, that the correct case number is 431-3625726

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Nevertheless, please note that the borrower still would have qualified for FHA financing had the loan been manually underwritten without the child support income. Although the qualifying ratios would exceed the benchmark guidelines, as explained above, the Department permits approval of a loan to a borrower with high qualifying ratios so long as significant compensating factors justify approval. Here, the borrower had an excellent credit history with no outstanding balances and high credit bureau scores (Exhibit I-5), and the borrower's income had increased by about 12.5% between 1999 and 2000 (Exhibit I-6), thereby evidencing the potential for increased income and ability to devote a greater portion of income to housing expenses than in the past. The borrower also had only \$339 in monthly debt (Exhibit I-7), which consisted primarily of an automobile lease (Exhibit I-5), thereby reflecting a conservative attitude towards the use of credit. Significantly, the Department has acknowledged all of these items as significant compensating factors that would justify approval of a loan to a borrower with qualifying ratios that exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 97-26.

Finally, with respect to the cash reserves, we recognize that the reserves noted in the file may have been derived from gift funds. Please note that to the extent any gift funds may have been included in the cash reserves, such inclusion occurred in error and does not reflect a Company practice. In this case, however, the deficiency constituted at worst harmless error and did not affect the borrower's eligibility for FHA financing. Because cash reserves were not required to qualify the borrower for the loan, and given the additional compensating factors noted above, the borrower still would have been approved without the reserves.

b. - FHA Case No. 561-7475697

In the case, the Supplement alleges that Apreva did not properly verify the source of funds used for the down payment and/or closing costs. Specifically, it alleges that alternative documentation for an asset account with BECU included only one month's bank statement. It further alleges that Apreva did not adequately verify that non-profit gift funds were received into escrow before the seller's donation was provided to the non-profit because the wire transfer was not dated.

Apreva has been unable to locate the file. While we will continue to search for the file, we cannot respond fully to the allegations in the Supplement at this time. Having said that, with respect to the bank account, it is Apreva's policy and practice to obtain at least two months' bank statements showing three months' balances whenever alternative documentation is used. With respect to the DAP funds, the Supplement suggests that Apreva should have obtained better evidence of the wire transfer. Such evidence, however, was not required. As explained above, Page 2-11 of HUD's Single Family Reference Guide requires three items in verifying DAP funds: (1)

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evidence from the donor of the amount of the gift; (2) evidence that no repayment from the borrower is required; and (3) evidence of the transfer of funds, which can be shown as a transaction on the HUD-1. http://www.hud.gov:80/offices/hsg/sfh/ref/sfhp2-11.cfm (Exhibit J). We are confident that Apreva complied with these requirements in this case, insofar as the file would contain a gift letter reflecting the amount of the gift and that no repayment from the borrower was required, as well as a copy of the HUD-1 reflecting the settlement agent's receipt of the funds. Evidence of the wire transfer was not required.

c. - FHA Case No. 569-0532591

In this case, the Supplement alleges that Apreva approved the loan with qualifying ratios of 44.5% and 44.5% without sufficient compensating factors. It further alleges that the qualifying ratios were understated because Apreva did not compute the borrower's income properly. It states that the underwriter used \$2,990 per month for the borrower's income, but that the hourly rate on the pay stub reflected \$2,331 per month, the 2001 W-2 form supports average monthly earnings of \$2,353, the 2000 W-2 form supports average monthly earnings of \$2,664, and the year-to-date earnings on the February 22, 2002 pay stub reflect an average of \$3,354 per month. The Supplement states that a 1.5-month average is insufficient for qualification purposes, that additional documentation to determine the average income should have been obtained, and that the borrower's ratios are likely higher than those reflected on the MCAW. In addition, the Supplement argues that Apreva did not ensure that the file contains complete bank statements because pages 3 and 5 were missing, and that the Company did not adequately verify that non-profit gift funds were received into escrow before the seller's donation was provided to the non-profit because there was no evidence of the wire transfer. Finally, the Supplement alleges that Apreva did not identify the source of funds for a debt to Arcadia Financial in the amount of \$14,414 paid off prior to closing, and therefore did not ensure that it was actually paid off rather than refinanced or paid by an interested party.

Apreva has been unable to locate the file. While we will continue to search for the file, we cannot respond fully to the allegations in the Supplement at this time. Having said that, with respect to the DAP funds, as noted above, FHA guidelines require evidence from the donor of the amount of the gift and that no repayment from the borrower is required, and they specifically state that evidence of the transfer of funds can be shown as a transaction on the HUD-1. See http://www.hud.gov:80/offices/hsg/sfh/ref/sfhp2-11.cfm (Exhibit K). We are confident that Apreva complied with these requirements, insofar as the file would contain a gift letter reflecting the amount of the gift and that no repayment from the borrower was required, as well as a copy of the HUD-1 reflecting the closing agent's receipt of the funds. Evidence of the wire transfer was not required.

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d. FHA Case No. 431-3719006

In the loan with qualifying ratios of 44% and 48.24% without sufficient compensating factors and that the justifications on the MCAW that the borrower had good job stability for two years and had re-established good credit after a bankruptcy were inadequate to justify loan approval. The Supplement further alleges that the borrower's effective income was overstated because the underwriter used 40 hours per week even though the Verification of Employment ("VOE") form indicated that the borrower worked about 25 hours per week. It states that the average monthly income for 2001 and year-to-date income was \$1,365 per month, while the underwriter used \$1,733 for qualification purposes. In addition, the Supplement alleges that Apreva did not verify that the non-profit gift funds were received into escrow before the seller's donation was made to the non-profit because there was no evidence of the wire transfer. Finally, the Supplement alleges that there was no verification of rent in the file and that the VOE form is dated one week after settlement.

With respect to the borrower's qualifying ratios, the ratios were only 33% and 37% (Exhibit L-1), not 44% and 48.24% as suggested in the Supplement. Thus, while the front-end ratio exceeded the benchmark quideline, the back-end ratio was significantly lower than the benchmark guideline of 41%. Moreover, significant compensating factors offset the front-end ratio. Initially, HUD has expressly stated that greater latitude is permissible on the front-end ratio. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-12(A). In addition, the borrower's credit report reflected a stellar credit history since his bankruptcy was discharged three years earlier in February 1999 (Exhibit L-2). There had been no late payments on any accounts since the bankruptcy was discharged, and the borrower had only \$70 in monthly debt, which reflected limited use of credit. The borrower's housing payment also decreased from \$750 per month to \$689.83 per month (Exhibit L-1). The Department has expressly recognized the limited use of credit and a minimal increase in housing expenses as significant compensating factors that would justify approval of a loan to a borrower with high qualifying ratios. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 97-26. Thus, these factors were sufficient to offset the front-end ratio in the case, especially given that the back-end ratio was only 37%.

With respect to the borrower's income, Apreva recognizes that the year-to-date income on the VOE reflects only about 33 hours per week **(Exhibit L-3)**.²⁰ Even using

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The VOE reflects \$13,190.29 in regular employment earnings through October 28, 2001, and indicates that the borrower earned \$10 per hour. \$13,190.29 divided by 10 months equals \$1,319.03 per month. \$1,319.03 divided by \$10 equals 131.9 hours worked per month, or 33 hours per week (i.e., 131.9 hours divided by four weeks).

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the lower income, however, the borrower still would have qualified for FHA financing. Working 33 hours per week for \$10 per hour, the borrower would have earned \$1,430 per month (i.e., \$10 x 33 hours per week x 52 weeks / 12 months). Consideration of \$1,430 per month would yield qualifying ratios of 38.8% and 42.8% (Exhibit L-1). As explained above, however, significant compensating factors were documented in the file and would have justified approval of the loan. Thus, while we recognize that the income may have been overstated, and while we have brought this issue to the attention of Company employees, any deficiency in connection with this matter constituted at worst harmless error in the

With respect to the DAP funds, the Supplement suggests that Apreva should have obtained evidence of the wire transfer. Such evidence, however, was not required. As previously noted, Page 2-11 of HUD's Single Family Reference Guide requires three items in verifying DAP funds: (1) evidence from the donor of the amount of the gift: (2) evidence that no repayment from the borrower is required; and (3) evidence of the transfer of funds, which can be shown as a transaction on the See http://www.hud.gov:80/offices/hsg/sfh/ref/sfhp2-11.cfm. complied with these requirements in this case. The file contained a Gift Letter and other items evidencing the amount of the gift and that no repayment from the borrower was required (Exhibit L-4), as well as a copy of the wire transfer reflecting transfer of the funds (Exhibit L-5), though such documentation was not required. Note that although the transfer statement is not dated, it was obtained and placed in the loan file prior to closing, at which time the seller's donation to the DAP provider was furnished. This timing is evidenced by the clearance of the condition for such evidence on March 5, 2002 (Exhibit L-6), two days before closing on March 7, 2002 (Exhibit L-7). No further documentation was required in this instance.

Regarding the verification of rent, while we have been unable to locate a copy of the verification in the file, this file was endorsed over two years ago and we are no longer required to maintain the file documentation. See HUD Handbook 4000.2 REV-2, ¶ 5-10; Mortgagee Letter 96-29. Moreover, we believe that a rental verification was obtained at the time of loan origination. Apreva would not have approved the file and the investor would not have purchased the file absent such a verification, nor would the underwriter have referenced the rental payment on the MCAW. Moreover, the borrower certified to the rent on his loan application (Exhibit L-8) and there is no reason to question the borrower's veracity.

Finally, regarding the date of the VOE, the Supplement suggests that the loan closed on February 28, 2002 and that the VOE is dated one week after settlement. This is incorrect. The written VOE was obtained in November 2001 (Exhibit L-3), four months prior to settlement. In addition, Apreva obtained a verbal VOE on March 7, 2002 (Exhibit L-9), in order to confirm that the borrower still worked for the same

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employer on the day of closing. While the initial closing date was scheduled for February 28th in this case, such that the date on the first page of the HUD-1 executed by the borrower reflects February 28th, please note that the borrowers and escrow officer signed the HUD-1 on March 6th, and the seller's HUD-1 was not executed until the next day on March 7th (Exhibit L-7). Apreva properly obtained the written VOE prior to closing and it obtained a verbal VOE on the day of closing.

e. – FHA Case No. 431-3731876

In the case, the Supplement alleges that Apreva did not document the borrower's income stability. Specifically, it alleges that the qualifying ratios were overstated because the income was not properly evaluated. It states that the underwriter improperly included 25 hours of overtime income per week because, while the borrower had worked for her current employer for approximately six months earning base pay of \$15 per hour with guaranteed overtime of 25 hours per week, the file contained eight copies of weekly pay stubs, seven of which showed zero to 7.5 hours of overtime per week and only one of which reflected overtime sufficient to use 25 hours per week. The Supplement further notes that six months of overtime is insufficient for qualification purposes, and it concludes that use of only the borrower's base pay would yield qualifying ratios of 59% and 76%.

Here, the underwriter relied on the VOE form in calculating the borrower's income. The VOE indicated that the borrower earned \$15 per hour and worked an average of 65 hours per week, 25 hours of which was overtime (Exhibit M-1). These figures yielded total income of \$3,900, which included \$2,600 in base pay and \$1,300 in overtime. We recognize, however, that the pay stubs reflected less than 25 hours per week in overtime and that the borrower had been working for the current employer for only six months. The inclusion of 25 hours of overtime was in error and does not reflect company policy or procedure. Nevertheless, while we agree that 25 hours of overtime should not have been included in the borrower's effective income, any deficiency in connection with this matter constituted at worst harmless error and the borrower still qualified for the FHA loan.

Initially, the fact that the borrower had been working for the current employer for only six months did not require the underwriter to exclude overtime income altogether. FHA guidelines provide that, with respect to the inclusion of overtime in qualifying income, "[p]eriods of less than two years may be acceptable provided the underwriter adequately justifies and documents his or her reason for using the income for qualifying purposes." HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-7(A). Thus, while we agree that the inclusion of 25 hours of overtime may have been inappropriate, the inclusion of some overtime was proper based on the FHA guidelines. The VOE expressly stated that the borrower was "guaranteed up to 25 hours of overtime each week" and that

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overtime income was likely to continue (**Exhibit M-1**). The employer also had previously furnished a letter confirming that overtime existed (**Exhibit M-2**). Thus, because overtime was an integral component of the borrower's job, the inclusion of some overtime income was appropriate. The file contained eight pay stubs reflecting overtime income averaging \$229.50 per week or \$994.50 per month, and shift differential income averaging \$26.60 per week or \$115.24 per month, yielding \$1,109.74 per month in addition to base pay (**Exhibit M-3**). The addition of these funds to the borrower's base pay of \$2,600 per month yields total monthly earnings of \$3,709.74. Consideration of \$3,709.74 in effective income, rather than the \$3,900 used by the underwriter, yields qualifying ratios of 40.68% and 52.89% (**Exhibit M-4**).

Although consideration of the lesser income yields qualifying ratios above HUD's benchmark guidelines, the borrower still would have qualified for FHA financing. As previously noted, the Department permits approval of a loan to a borrower with high qualifying ratios where significant compensating factors exist. Here, significant compensating factors expressly acknowledged by the Department were present and justified approval of the loan. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 97-26. First, the borrower had an excellent credit history. Her credit report reflected one open account, an automobile loan with a perfect 14-month payment history, a number of revolving accounts with a late payment on only one of the accounts, which was paid in full prior to closing, and several paid accounts, as well as high credit bureau scores of 619 and 643 (Exhibit M-5). The borrower also had substantial cash reserves of \$2,700 (Exhibit M-4), and her income had steadily increased over the past few years (Exhibit M-6), thereby evidencing the potential for increased income and ability to devote a greater portion of income to housing expenses than in the past.

In sum, while we recognize that the underwriter included too much overtime income in the borrower's effective income, the borrower still would have qualified for FHA financing in this case. Although the ratios exceeded HUD's benchmark guidelines, significant compensating factors recognized by the Department were documented in the file and would have justified loan approval.

- FHA Case No. 561-7498436

In this case, the Supplement alleges that: (1) there were invalid or insufficient compensating factors to justify high qualifying ratios; (2) Apreva did not document the stability of the borrower's income; (3) the source of funds was not verified; and (4) the borrower was not creditworthy. We address each allegation in turn below.

f.

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<u>First</u>, with respect to the borrower's qualifying ratios, the Supplement alleges that the ratios were 31.28% and 48.14%, but that there were no compensating factors. In addition, it alleges that Apreva qualified the borrower using a buydown interest rate of 5.875%, which would increase by one percent per year for the next two years, and that Apreva's remarks were not adequate to justify the excessive ratios. It notes that ratios should rarely be exceeded when buydown rates are used and that consideration must be given to the borrower's ability to absorb future payment increases. The Supplement further alleges that the Quality Control reviewer noted that the ratios were understated because Apreva did not verify and/or compute income and liabilities correctly and that the correct ratios were 32.17% and 51.37%.

Contrary to the suggestion in the Supplement, while the borrowers were qualified with ratios above the benchmark guidelines, significant compensating factors were documented in the file and justified approval of the loan in this case. First, the borrowers had substantial cash reserves of \$2,053 (Exhibit N-1). Second, the coborrower had additional income not included in effective income that directly affected the borrowers' ability to repay the mortgage. The co-borrower earned over \$2,000 per month as a patient care representative (Exhibit N-2). The underwriter did not include this income in the borrowers' effective income because the VOE form indicated that the employment was "probationary." The co-borrower, however, explained that this probationary period was temporary for a period of six months, as required by the union. and that the employment was expected to be stable and long term (Exhibit N-3). Furthermore, the co-borrower was receiving this income, and the additional \$2,000 per month was substantial. Third, the co-borrower was to receive a pay increase at her part-time job a few months after closing that would yield an additional \$8.66 to \$34.66 per week (Exhibit N-4). Finally, the borrower's income had been steadily increasing each year, thereby demonstrating the potential for increased earnings and ability to devote a greater portion of income to housing expenses than in the past (Exhibit N-5). The Department has expressly recognized these considerations as significant compensating factors that would justify approval of a loan to a borrower with qualifying ratios that exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 97-26. Thus, while we recognize that the compensating factors could have been better explained in the Remarks section of the MCAW, the MCAW did note the co-borrower's receipt of additional income not included in effective income, the file documented other compensating factors, and the borrowers qualified for FHA financing.

With regard to the buydown interest rate, Apreva's underwriters understand and appreciate that they must consider the possible "payment shock" associated with such financing arrangements and that, in such cases, the qualifying ratios should rarely be exceeded and consideration must be given to the borrower's ability to absorb payment increases. <u>See</u> Mortgagee Letter 97-26. Apreva complied with these requirements in

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the case. The underwriter considered the possible "payment shock" and the borrowers' ability to absorb eventual increases in payments, as evidenced by her reference on the MCAW to the additional income not included in effective income (Exhibit N-1). While the qualifying ratios exceeded the guidelines, and although the guidelines suggest that the ratios should rarely be exceeded when buydowns are used, there is no prohibition against exceeding the guidelines under such circumstances and the underwriter reasonably determined that sufficient compensating factors justified the ratios in this case.

Insofar as the borrower's income and liabilities are concerned, the amounts reflected on the MCAW appear to be correct. The MCAW reflects \$3,956 in gross monthly income, \$3,610 in base pay for the borrower and \$346 in base pay for the coborrower (Exhibit N-1). The borrower's income is supported by both a VOE (Exhibit N-6) and pay stubs (Exhibit N-7). The VOE reflected full-time employment of at least 40 hours per week and year-to-date earnings of \$11,341.56, which included \$650.64 in overtime income. The borrower therefore had earned \$10,690.92 during the first three months of 2002, or \$3,563.64 per month. The borrower's pay stubs similarly reflected regular hours ranging from 45 to 60 hours per week and continuous overtime income. The co-borrower's income was likewise supported by the file documentation. As previously noted, the underwriter did not consider the co-borrower's income from her full-time employment because it was reflected as "probationary" on the VOE. A VOE from the co-borrower's part-time employer, however, reflected \$10 per hour at least eight hours per week (Exhibit N-4), which yields \$346 per month (i.e., \$10 per hour x 8 hours per week x 52 weeks / 12 months), and the underwriter considered this amount on the MCAW (Exhibit N-1). The borrowers' income was computed properly and the qualifying ratios were accurately determined.

Second, with respect to the borrower's income, the Supplement alleges that the income was overstated because it should have been calculated based on a 15-month average due to the nature of the employment. It states that the VOE form indicated \$41,144.50 in 2001 and \$11,341.56 as of March 27, 2002, which yields a 15-month average of \$3,499 per month, not \$3,610 used by the underwriter. Contrary to the suggestion in the Supplement, the underwriter was not required to average the borrower's income in this case. The borrower was a full-time W-2 employee of Alaska Airlines (Exhibits N-5 and N-6), not an independent contractor or commissioned employee. In fact, the VOE expressly stated that "no commissions are paid for any position at Alaska Airlines" (Exhibit N-6). Thus, there was no requirement to average the income and, as explained above, the income used by the underwriter was supported by the file documentation. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-7.

<u>Third</u>, with respect to the source of funds, the Supplement notes the Quality Control reviewer's comments that a printout provided for the borrower's liquid asset

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account was not dated or signed by the bank and does not cover the appropriate period, and that the source of funds for a large deposit of \$3,671 on March 8, 2002 was not addressed. The Supplement further alleges that the non-profit gift funds were not properly documented because there was no wire transfer to evidence they were received into escrow before the seller's donation was provided to the non-profit. Contrary to these allegations, the source of funds was properly documented in this case.

Regarding the printout for the borrower's liquid asset account, we are unaware of any requirement that such a printout contain the date or signature of the bank. Moreover, all asset documentation in the file was appropriately dated (Exhibit In addition, the asset documentation in the file covers a two-month period, including February and March 2002, which is sufficient time under the FHA guidelines. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 3-1(F). While we recognize that there was a large deposit on March 8th and that the file should contain a written explanation from the borrowers indicating the source of the deposit, an explanation may in fact have been obtained prior to closing. In accordance with Handbook requirements, it is Apreva's policy and practice to obtain a written explanation of any large increases in a borrower's account, and such an explanation in this case may have been obtained and submitted to the investor without being copied for Apreva's files. We have reminded Company employees of their obligations in this regard, including the need to maintain complete records. Nevertheless, any deficiency in connection with this matter constituted at worst harmless error. As noted in the Supplement, the deposit was for \$3,671 on March 8th. The borrower, however, had already made the \$500 earnest money deposit and needed only \$499.97 at closing in April (Exhibit N-9). Based on his prior paychecks (Exhibit N-7), the borrower would have received a paycheck from Alaska Airlines on March 31st, a few days prior to closing but after the date of the last bank statement (Exhibit N-8), which was sufficient to cover the \$499.97 at closing.

Regarding the DAP funds, the Supplement suggests that Apreva should have obtained evidence of the wire transfer. Such evidence, however, was not required. Again, Page 2-11 of HUD's Single Family Reference Guide requires three items in verifying DAP funds: (1) evidence from the donor of the amount of the gift; (2) evidence that no repayment from the borrower is required; and (3) evidence of the transfer of funds, which can be shown as a transaction on the HUD-1. See http://www.hud.gov:80/offices/hsg/sfh/ref/sfhp2-11.cfm. Apreva complied with these requirements in this case. The file contained a Gift Letter and other items evidencing the amount of the gift and that no repayment from the borrower was required (Exhibit N-10), and the closing agent's receipt of the funds was reflected on the HUD-1 (Exhibit N-9). No further documentation was required in this instance.

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<u>Finally</u>, with respect to the borrower's creditworthiness, the Supplement alleges that the underwriter understated the borrower's liabilities. It notes the Quality Control reviewer's comment that the underwriter excluded a \$4,366 debt with monthly payments of \$71. We recognize that the \$71 debt should have been included in the borrower's liabilities. Please note that its exclusion was inadvertent and resulted from confusion arising from several credit letters referencing the account. In any event, while inclusion of this debt would raise the back-end ratio from 48.14% to 49.93% (**Exhibit N-1**), the borrower still would have qualified for FHA financing. As explained above, the borrowers had substantial cash reserves, additional income not included in effective income, the expectation of a pay increase, and steady increases in earnings, thereby demonstrating the potential for increased income and an ability to devote a greater portion of income to housing expenses than in the past. These considerations constituted significant compensating factors expressly recognized by the Department that would have justified loan approval.

g. – FHA Case No. 431-3659062

In the case, the Supplement alleges that Apreva did not document the borrower's income stability, overstated the borrower's income, and approved the loan with high qualifying ratios and insufficient compensating factors. Specifically, it alleges that the employer did not state the borrower's probability of continued employment and that the borrower had not established a sufficient length of employment to have his income considered for qualifying purposes. It alleges that the borrower was apparently in school prior to the employment, but that the application showed only 11 years of school and he was not obtaining higher education, thereby suggesting that he should have had a combination of two years' employment. The Supplement further alleges that the co-borrower's year-to-date income average was \$1,247 per month, but that the underwriter used \$1,850 without explaining how this amount was derived or why the co-borrower's average monthly income increased since 2001. The Supplement states that the underwriter should have used \$1,645 in monthly income based on a 15-month average (including bonus and overtime) reflected on the VOE. Finally, the Supplement alleges that, absent the borrower's income and using the correct income for the co-borrower, the qualifying ratios increase from 33.14% and 38.69% to 72.16% and 84.26% and the loan would not have been approved.

The underwriter properly considered the borrower's income in this case. While the borrower was 20 years old, he had been in high school prior to obtaining employment. This fact is reflected in both a processor certification indicating that the school verified the borrower's enrollment (Exhibit O-1) and a letter from the borrower explaining that he had been in school (Exhibit O-2). The borrower also certified to his education on the loan application (Exhibit O-3). The fact that the borrower had attended only 11 years of school at the age of 19 does not alone suggest that the

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borrower should have had additional employment prior to the 11 months he had been on the current job. There could be any number of reasons why the borrower was delayed in school that would not have necessitated a prior job (e.g., starting school late at an early age, being held back a year or two, suffering an illness that required a delay, etc. . . .). Regardless of why the borrower's schooling was delayed, there is no reason to question the borrower's certifications that he was in high school prior to obtaining employment or the school's certification to his enrollment. Apreva adhered to FHA documentation requirements in this case and the borrower's income was stable, as evidenced by the VOE form, pay stubs and W-2 forms (Exhibit O-4).

With respect to the co-borrower's income, contrary to the suggestion in the Report, and while the Quality Control reviewer had suggested that a 15-month average may have been appropriate, the underwriter properly computed the co-borrower's income in a manner acceptable under FHA guidelines. As reflected on the MCAW, the underwriter considered \$1,850 for the co-borrower (Exhibit O-5). This amount was supported by the file documentation. The underwriter relied on the co-borrower's most recent pay stub, which showed \$432.12 in regular earnings for one week (Exhibit O-6). This amount yields \$1,872.52 per month (i.e., \$432.12 x 52 weeks / 12 months). Thus, the \$1,850 considered by the underwriter was actually understated. The co-borrower was a W-2 employee of the Kmart Corporation (Exhibit O-7), not an independent contractor or commissioned employee, and we are unaware of any requirement to average income under such circumstances. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-7.

Having said that, please note that, even using the \$1,645 for the co-borrower as suggested in the Report, the borrowers still would have qualified for FHA financing. Consideration of \$1,645 would yield qualifying ratios of 35% and 41% (Exhibit O-5). While the front-end ratio would exceed the benchmark guideline, significant compensating factors would have justified loan approval. Initially, the Department expressly stated that greater latitude is permitted on the front-end ratio. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-12(A). Moreover, as explained in the Remarks section of the MCAW, the borrowers had good credit (i.e., there was only one unpaid collection for the borrower, but it was old and the file contained a letter of explanation indicating that it was a mistake) and had been making timely housing payments for the past year, they had limited debt of only \$199 per month, and their housing payments were decreasing by 12%. Thus, significant compensating factors were documented in the file and the borrowers qualified for the FHA loan.

h. – FHA Case No. 431-3747456

In the case, the Supplement alleges that: (1) there were insufficient compensating factors to offset the high qualifying ratios; (2) the borrower's

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income stability was not verified; and (3) the source of funds was not documented. We address each matter in turn below.

<u>First</u>, with respect to the borrower's qualifying ratios, the Supplement alleges that the back-end ratio was 45.4%, but that there were no compensating factors to justify the high ratio. It further alleges that the interest rate was a buydown rate of six percent that would increase by one percent per year for the next two years and that Apreva disregarded the requirement that, when buydown rates are used, ratios should rarely be exceeded and consideration must be given to the borrower's ability to absorb future payment increases.

Contrary to the suggestion in the Supplement, and while we recognize that the MCAW should have contained greater detail in the Remarks section, significant compensating factors were documented in the file in this case. The borrower had a good credit record with no amounts past due (Exhibit P-1) and a stellar rental history for the past two years (Exhibit P-2). HUD has expressly recognized such considerations as acceptable compensating factors. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 97-26. While the loan was a buydown, the co-borrower was in school and was expected to graduate and begin working full time, thereby bringing in additional income to contribute towards the increased housing expenses. Given that the borrower had been making timely housing and other payments for several years, there was no reason to question his ability to continue to do so.

<u>Second</u>, with respect to the borrowers' income, the Supplement alleges that the Quality Control reviewer noted that the qualifying ratios were understated because the co-borrower's income was overstated. Specifically, it alleges that the employer verified that the co-borrower worked only during the fall and spring semesters, with 2001 earnings of \$760 and year-to-date earnings of \$1,530, and that she was paid \$510 per month. It alleges that the underwriter used \$1,020 for qualifying purposes, but that the income was not seasoned and that the true monthly average could not be determined based on the nature of the employment. In addition, the Supplement indicates that the underwriter overstated the income from the co-borrower's second job. It notes the Quality Control reviewer's remark that the co-borrower was paid by "contract" and that the underwriter used \$407 per month, while the pay stub showed year-to-date and current earnings of \$665 as of February 16th and the VOE showed year-to-date earnings of \$665 as of April 8th, suggesting that the borrower had not been paid in two months. The Supplement also alleges that the file contained only a VOE and no pay stubs for the borrower.

With respect to the co-borrower's income, we recognize that her income was overstated in this case. As reflected on the MCAW, the underwriter used \$1,020 from

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the co-borrower's primary job and \$407 from her part-time job (Exhibit P-3). It appears that the underwriter misread the VOE to read \$510 in bi-weekly income from the primary job, rather than \$510 in monthly income (Exhibit P-4). The \$407 part-time earnings, however, were supported. The pay stub referenced in the Supplement reflects \$665 year-to-date earnings as of February 16, 2002 (Exhibit P-5), and the VOE reflects \$665 as of March 25, 2002 (Exhibit P-6). Note, however, that the paycheck was issued on March 5, 2002, just two weeks before the dates used on the VOE, and it appears that the employer used the date on the last paycheck to complete the VOE. In addition, contrary to the suggestion in the Report, the file contained not only a VOE (Exhibit P-7), but an Earnings Statement (Exhibit P-8) and several pay stubs for the borrower (Exhibit P-9).

Furthermore, please note that using the correct income of \$510 from the coborrower's primary job still would have allowed the borrowers to qualify for the loan. Using the correct income, the borrowers' qualifying ratios would increase to 33% and 51% (Exhibit P-3). Although the ratios would exceed HUD's benchmark guidelines, as previously noted, the borrower had a good credit record with no amounts past due and a stellar rental history for the past two years. Thus, significant compensating factors would have justified approval of the loan.

Finally, with respect to the source of funds, the Supplement alleges that the gift documentation was inadequate because it did not contain evidence the borrower had received a gift check in the amount of \$2,000 and a \$2,921 increase in the checking account was not verified. Regarding the gift, while the donor originally intended to furnish a \$2,000 gift in this case, she ultimately decided to provide \$4,000. To this end, the file contained a gift letter, dated April 25, 2002, indicating the borrower's mother would provide a \$4,000 gift (Exhibit P-10), confirmation from the donor's bank that the donor maintained sufficient funds in her checking account to make the gift as of the date of the gift letter (Exhibit P-11), a copy of the personal gift check from the donor made payable to the borrower for \$4,000 on April 25, 2002 (Exhibit P-12), and a copy of the borrower's account history reflecting that the funds were deposited on May 6, 2002 (Exhibit P-13). The borrower received and deposited the gift funds. Regarding the \$2,921 increase in the borrower's checking account, while we agree that the source of funds for the increase should have been documented, and while it is Apreva's policy and practice to verify such increases, there is no reason to believe that the funds were obtained from an improper source in this case.

i. – FHA Case No. 561-7540790

In this case, the Supplement alleges that Apreva did not document the borrower's income stability, source of funds, or creditworthiness. Specifically, the Supplement alleges that the qualifying ratios were understated because, while the

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borrower's year-to-date average monthly income was \$1,697 and yielded monthly income of \$1,857 when combined with the borrower's 2001 earnings, the underwriter used \$1,939 for qualification purposes. The Supplement states that the underwriter used an old pay stub to calculate the monthly income and that the income should be \$1,765 per month based on the most recent pay stub in the file. The Supplement further alleges that Apreva did not adequately verify that DAP funds were received into escrow prior to the seller's donation to the non-profit because there was no evidence of a wire transfer in the file. Finally, the Supplement alleges that the underwriter did not require an explanation for a derogatory payment history. It notes that the borrower did not have traditional credit and had two alternative credit references, one of which was a print screen that did not show the lender but reflected five delinquent payments in the past 12 months.

With respect to the borrower's income, the income was not overstated on the MCAW. To the extent the income may have been inaccurate, it appears that the income was understated. As stated in the Supplement, the underwriter used \$1,939 to qualify the borrower (Exhibit Q-1). The most recent pay stub reflected \$506.25 for one week, or \$2,193.75 per month (i.e., \$506.25 x 52 weeks / 12 months) (Exhibit Q-2). Excluding the holiday income reflected in the pay stub, the borrower would have earned \$434.25 for the week, or \$1,881.75 per month. Note, however, that the borrower also earned overtime income, which averaged \$353 over 30.5 months (Exhibit Q-3). The borrower's income therefore ranged anywhere from \$2,234.75 (i.e., 1,881.75 + 353) to \$2,546.75 (i.e., \$2,193.75 + \$353), and the amount used by the underwriter was conservative.

With respect to the DAP funds, the Supplement suggests that Apreva should have obtained evidence of the wire transfer. Such evidence, however, was not required. As previously noted, Page 2-11 of HUD's Single Family Reference Guide provides that evidence of the transfer of funds can be shown as a transaction on the HUD-1. See http://www.hud.gov:80/offices/hsg/sfh/ref/sfhp2-11.cfm. Here, the HUD-1 reflected the DAP funds (Exhibit Q-4), and the file documentation satisfied FHA requirements.

Finally, with respect to the borrower's creditworthiness, as noted in the Supplement, the borrower's credit report reflected a lack of traditional credit and thus no derogatory items (Exhibit Q-5). Apreva, however, obtained two alternative credit references, one from a utility company (Exhibit Q-6) and one from Comcast (Exhibit Q-7). While the printout from Comcast did not reflect the creditor's name, it did include a telephone number, which is the number for Comcast. Furthermore, while the printout reflected a few late payments, it indicated that there was no amount past due and that the creditor considered the borrower to be in good standing. In addition, the alternative credit reference from the utility company reflected a stellar six-year payment history, the

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borrower's credit report reflected no monthly obligations, a verification of rent confirmed timely housing payments for the past six years (Exhibit Q-8), and the borrower's housing expenses were increasing by only \$130 (Exhibit Q-1). Given all of these circumstances, the underwriter made a reasonable determination that the borrower was creditworthy and could be expected to make timely mortgage payments.

j. – FHA Case No. 561-7714083

In the case, the Supplement alleges that Apreva: (1) did not verify the source of funds; (2) did not properly review the appraisal; and (3) did not document and/or resolve file discrepancies. We address each matter in turn below.

<u>First</u>, with respect to the source of funds, the Supplement alleges that Apreva did not ensure that the file contained all of the required information for gifts insofar as the borrower did not sign the gift letter. While we recognize that the borrower did not sign the gift letter in this case, please note that the omission in this instance was inadvertent and does not reflect Company policy or procedure. Apreva requires that borrowers execute gift letters and has reminded Company employees of this requirement. Having said that, however, the fact that the borrower did not execute the gift letter in this case does not suggest that the gift was not provided.

Second, with respect to the appraisal, the Supplement notes the Quality Control reviewer's finding that the file did not contain classification as to the process and likelihood of a variance being granted with respect to the rebuilding of a property that was more than 75% destroyed by fire and had a zoning classification of "ML Limited Manufacturing." The Supplement further notes the Quality Control reviewer's observation that neither the appraiser nor underwriter called for a pest inspection to address the fact that the structure was ground level with water proximate to the structure. Regarding the rebuilding variance, because one was not required in this case, we do not believe the underwriter was required to determine the likelihood of obtaining a variance. Regarding the termite inspection, please note that the appraiser's comments expressly stated that the VC condition referred to a "non termite area" (Exhibit R-1).

Finally, with respect to purported file discrepancies, the Supplement alleges that there were two different copies of money orders used for \$5,000 in gift funds, one set furnished by the title company showing the borrower as the purchaser, and one set showing the original signature of the loan officer as the purchaser. The Supplement further alleges that there was no support in the file that the loan officer gifted her own funds to purchase the money orders and that her bank statement reflected merely that she had sufficient funds to make the gift, not withdrawals to show the actual donation.

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To document the gift in this case, Apreva obtained a gift letter, copies of money orders from the donor, and a copy of the donor's bank statement reflecting sufficient funds to make the gift **(Exhibit R-2)**. We now recognize that there are certain discrepancies in the file regarding the gift funds, and we are in the process of investigating them. There is no evidence, however, that the gift funds were not provided or that funds to close were derived from an impermissible source.

– FHA Case No. 431-3880566

In the case, the Supplement alleges that Apreva neither provided sufficient compensating factors to offset high qualifying ratios nor documented the borrower's income stability. Specifically, it alleges that Apreva overstated the borrower's income by \$1,999. It states that the underwriter used overtime to qualify the borrower, but that, although the borrower had a two-year history of overtime, the VOE stated that the overtime was not likely to continue. The Supplement alleges that exclusion of the overtime income would increase the qualifying ratios to 31.99% and 52.09%, and that none of the compensating factors listed in the Remarks section of the MCAW were adequate to justify approval of the loan.

Apreva agrees that the underwriter should not have included the borrower's overtime earnings in his qualifying income based on the statement in the VOE that the income was unlikely to continue. Please note that inclusion of the income was in error and does not reflect Company policy or procedure. Nevertheless, any deficiency in connection with this matter in the case constituted at worst harmless error and did not affect the borrower's eligibility for FHA financing. Contrary to the suggestion in the Supplement, there were significant compensating factors documented in the file that justified loan approval.

For example, the borrower had a good credit history. The credit report reflected only two derogatory items, which were four and one-half and six years old (Exhibit S-1). The borrower also had a flawless rental history (Exhibit S-2) and satisfactory payments of all other debts over the past 12 to 24 months (Exhibit S-1). Notably, the Department has expressly stated that, where a borrower has made timely payments of housing and other expenses over the past 12 to 24 months, there is little reason to doubt his or her ability to continue to do so despite having qualifying ratios that exceed the benchmark guidelines. See HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13(A). In addition, the borrower had over \$3,700 in cash reserves (Exhibit S-3), and his income was steadily increasing (Exhibit S-4), thereby evidencing the potential for increased earnings and ability to devote a greater portion of income towards housing expenses. Finally, even if the borrower's overtime could not be included in effective income, the most recent pay stubs reflected that it was earned and it at least constituted additional income that would directly affect the borrower's ability to repay the mortgage. The

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Department had recognized all of these considerations as significant compensating factors that would justify approval of a loan to a borrower with qualifying ratios that exceed the benchmark guidelines. <u>See</u> HUD Handbook 4155.1 REV-4, CHG-1, ¶ 2-13; Mortgagee Letter 97-26. Thus, while the underwriter erred in including the overtime income in effective income, the borrower still gualified for FHA financing.

III. CONCLUSION

The Report portrays Apreva as a poorly managed lender that disregards underwriting requirements and fails to address deficiencies brought to its attention. This characterization is unfair and unsupported by the evidence in this case.

Contrary to the suggestion in the Report, Apreva has generally complied with FHA underwriting requirements, made loans to qualified FHA borrowers, and established effective management supervision and controls. All of the loans cited in the Report were originated during a limited time period several years ago. The Company had recently reorganized and was experiencing rapid growth, and the lending industry was just beginning to understand HUD's expectations with respect to branch office operations. While Apreva naturally experienced certain growing pains and misunderstood the FHA requirement regarding exclusivity, the Company's management diligently addressed concerns brought to its attention and implemented numerous corrective actions to ensure the Company's adherence to FHA guidelines.

As detailed above, among other things, Apreva:

- reduced its wholesale business;
- hired in-house counsel:
- modified underwriting policies;
- terminated two underwriters and re-assigned one underwriter to a non-underwriting position;
- placed restrictions on one underwriter's activities;
- hired an Underwriting Manager;
- hired a Compliance and Branch Administrator;
- outsourced Quality Control;

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- conducted internal FHA training sessions;
- instituted routine underwriter meetings;
- closed six branch offices;
- terminated 28 loan officers;
- adopted new employment agreements;
- · adopted new procedures for establishing branch offices; and
- implemented monthly, bi-annual, and annual reviews of loan correspondents.

Apreva identified and responded to operational and underwriting concerns, and it has exercised responsible management supervision. The Company's success in this area is demonstrated by its low default/claim rate, and the concerns identified in the Report are no longer an issue at Apreva. Stringent controls are in place to ensure that Company personnel adhere to both Apreva's and HUD's rules and regulations. Moreover, the specific underwriting deficiencies alleged in Findings 1 and 3 focus largely on subjective decision-making matters, and the allegations tend to second-guess the underwriters' decisions without identifying actual violations of FHA requirements. While we appreciate that some underwriters may disagree with Apreva's decisions in these cases, the underwriting decisions substantially complied with FHA requirements.

In sum, Apreva has undergone substantial changes over the past few years. and the practices and loan transactions cited in the Report relate to activity prior to mid-2002. The Report neither reflects Apreva's current practices nor considers the changes that have occurred at the Company. In connection with Finding 1, Apreva generally complied with FHA requirements in the 38 cases cited in the Report and took corrective action when concerns were brought to its attention. In connection with Finding 2, Apreva has always paid the operating expenses of its branch offices and at no time permitted independent entities or non-employees to originate loans using the Company's FHA identification number. While a handful of employees were not exclusive to Apreva insofar as they also worked for other mortgage lenders on conventional loans, this situation arose due to a misunderstanding of FHA requirements, in no way affected any particular loan transactions, and was rectified prior to issuance of the Report. Finally, in connection with Finding 3, Apreva implemented timely Quality Control, has taken corrective action where necessary, adequately supervises its loan correspondents, and generally complied with FHA requirements in the specific cases cited in the Report.

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Throughout this proceeding, we hope the OIG will consider this response and supporting documentation. We trust that, after reviewing these materials, you will agree that Apreva generally complied with FHA requirements and that the penalties recommended in the Report are disproportionate to any deficiencies that may have occurred. If you have any questions concerning the matters discussed herein, please contact me at (425) 378-3795, or Apreva's Washington counsel, Phillip L. Schulman, at (202) 778-9027.

Thank you for your consideration.

Sincerely,



Dave Pederson Chief Executive Officer

Enclosures

cc: Phillip L. Schulman, Esq.

<u>No</u> .	Identifying Description	No.	Identifying Description
1	Legal Counsel	21	Loan Officer 8
2	Senior Underwriter	22	Loan Officer 9
3	Former Underwriter 1	23	Loan Officer 10
4	Former Underwriter 2	24	Loan Officer 11
5	Underwriting Manager	25	Loan Officer 12
6	Former Underwriter 3	26	Loan Officer 13
7	Current Underwriter 1	27	Loan Officer 14
8	Current Underwriter 2	28	Loan Officer 15
9	Current Underwriter 3	29	Borrower 4
10	Compliance & Branch Administrator	30	Borrower 5
11	Borrower 1	31	Borrower 6
12	Borrower 2	32	Borrower 7
13	Borrower 3	33	Borrower 8
14	Loan Officer 1	34	Borrower 9
15	Loan Officer 2	35	Borrower 10
16	Loan Officer 3	36	Borrower 11
17	Loan Officer 4	37	Borrower 12
18	Loan Officer 5	38	Borrower 13
19	Loan Officer 6	39	Borrower 14
20	Loan Officer 7		

OIG Evaluation of Auditee Comments

Comment 1 Apreva did not notify HUD of these changes within 10 days as required by HUD Handbook 4060.1 REV-1, Chapter 2. HUD was not notified of the June 2000 change of ownership. Further, although the response states that Apreva relocated its headquarters to Bellevue in the fall of 2003, the Home Office location was already moved to Bellevue by the time we began our review in May 2003.

Comment 2 We disagree that the defaults and claims have decreased significantly. Apreva only considered loans that were originated by Apreva that are currently in default. According to Neighborhood Watch, for all loans underwritten by Apreva with beginning amortization dates between June 1, 2002 and May 31, 2004, 76 loans defaulted within the first two years for a 4.34 percent default rate, 172 percent higher than all lenders monitored by the Santa Ana HOC. There were 10 claims on the 76 loans for a 13.16 percent claim/default rate, 170 percent higher than other lenders under the HOC. While these rates are down from when our audit started, they are not down significantly.

Additionally, Footnote 1 indicates that Apreva does not have a good understanding of the information available in Neighborhood Watch. Apreva alleges that the information in Neighborhood Watch is in error because it states

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that Apreva only originated 274 loans; however the option selected was "Single Lender – Originator by Institution." This option does not include those loans "funded" by Apreva.

Comment 3

The Senior Underwriter advised that she did operate in a supervisory capacity by providing guidance and some limited training to the other underwriters. She stated that there really was not any other supervision of the underwriting staff prior to hiring the Underwriting Manager in November of 2002.

Comment 4

The Olympia Underwriter stated that Apreva's President was her immediate supervisor, however the Senior Underwriter in Bellevue was her Underwriting Supervisor. When she was hired, she spent two weeks training with the Senior Underwriter and was told to call her if she had any questions. In addition, she stated that for a period of time the Senior Underwriter held bi-weekly conference calls to discuss underwriting issues.

Comment 5

Contrary to the CEO's statement in the response, Apreva's President, located in Olympia, did not oversee the underwriting function. The current CEO in his initial meeting with us stated that Apreva did not have an underwriting manager, however the Senior Underwriter performed some supervisory functions.

Apreva's current President advised that she did not want to get involved in the underwriting side of the business since she had limited knowledge of the underwriting process. When she became a business partner with the current CEO, she thought he would be a good partner since he would be bringing in an experienced staff to handle the underwriting.

The current Underwriting Manager confirmed this, stating that Apreva's current President did not directly supervise and was not involved with the underwriting side of Apreva's business. According to the current Underwriting Manager, the current President's primary role was to sell the mortgages to the secondary market and the current CEO ran the production/underwriting side of the business. The current Underwriting Manager also stated that the Senior Underwriter was the Underwriting Manager when she (the current Underwriting Manager) was performing the Quality Control function as an independent contractor and continued in that role until she was hired in November of 2002.

Comment 6

We agree that the current President's decision to hire the current Underwriting Manager proved to be an invaluable addition to Apreva's staff. However, the current Underwriting Manager advised that the Bellevue management was not responsive to her recommendations on numerous occasions.

Comment 7

We disagree that timely restrictions were placed on the Senior Underwriter. In July of 2001, Apreva's management was put on notice by the Quality Control reviewer (now the current Underwriting Manager) that the underwriting department had significant problems. Yet, the Senior Underwriter, who was the

only one managing the underwriters, was not placed on any restriction until February of 2002. Even though she was on restriction, she was allowed to work at two of Apreva's major loan correspondents' offices until our audit started, at which time she was moved back to the Bellevue Office. The Senior Underwriter advised that she was working at the loan correspondents' offices for sales and marketing reasons. She stated that she had a 15 year history approving loans for one of the loan correspondents, it helped with work flow, and was easier to get loans through if she worked on site.

According to the current Underwriting Manager, she and the President of Apreva repeatedly recommended that the Senior Underwriter's employment at Apreva be terminated due to her "horrible" underwriting. The Senior Underwriter had a history of poor performance despite the fact that she has over 20 years of underwriting experience, 10 of those years working with the current CEO.

Comment 8 We disagree that Apreva performed Quality Control reviews prior to hiring Compliance Services Inc. to perform the reviews. In our initial meeting with the current President, she stated that, prior to hiring the independent firm, she performed informal reviews of loans but did not do any formal Quality Control reviews. She also advised that she did not pay much attention to underwriting issues and left those up to the current CEO to manage.

Further, we asked Apreva to provide written documentation of their Quality Control Reviews for the period prior to hiring Compliance Services Inc., but they were unable to do so.

- **Comment 9** Apreva alleges that the current President maintained records, however this is contrary to statements made by her at earlier meetings. (See Comment 8)
- Comment 10 Apreva acknowledges that they had difficulties implementing timely Quality Control in the past. The new Quality Control Plan that Apreva included with its response appears to comply with HUD's requirements; however, we have not determined if Apreva adheres to the new plan.
- Comment 11 The Compliance and Branch Administrator's branch files contained a November 30, 2001 copy of Mortgagee Letter 00-15 that specifies the requirements for branch offices; yet a number of the branch offices were not compliant with these requirements.
- Comment 12 As late as January 2003, Apreva entered into a Branch Operating Agreement that was contrary to HUD's requirements. The agreement stated, "...nothing herein is intended to create a partnership, joint venture, association, principal/agent or employer/employee relationship. The parties intend that, for the purposes of this Agreement, BRANCH OPERATING COMPANY is an independent contractor." Also in an August 2003 draft Branch Manager Employment Agreement there was a statement that the branch is "an independent legal entity and separate and

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distinct from Employer." Mortgagee Letter 00-15 dated May 1, 2000 specifically states, "... separate entities may not operate as "branches" of a HUD/FHA approved mortgagee and if the separate entity lacks HUD/FHA approval, its mortgages constitute third party originations which violate Departmental requirements."

- Comment 13 We agree that the correct position title should be Senior Underwriter and have changed the report accordingly. We used the titles "Chief Underwriter" and "Underwriting Manager" because these terms were used by other Apreva staff in reference to the Senior Underwriter. However, as stated in Comment 3, the Senior Underwriter told us she did act in a supervisory capacity. We have also modified the report to clarify that along with the hiring of the current CEO, his entire branch operation, including his prior staff, was added to Apreva's operations.
- Comment 14 We disagree that Apreva has substantially complied with FHA underwriter requirements. As detailed in Comments 18 to 26, the loans were not eligible for FHA endorsement. As detailed more fully in Finding 3, and Comments 5 to 8, Apreva did not have adequate and continuous controls in place to monitor underwriting performance, and management did not implement timely corrective measures to cure deficiencies in underwriting. The President did not oversee Apreva's underwriting operations; the only management function performed was by the Senior Underwriter who had a history of poor performance.
- Comment 15 Post Endorsement review ratings and default information for FHA loans are readily available on HUD's Neighborhood Watch system for analysis by Apreva. The primary responsibility lies on Apreva, not HUD, to monitor its underwriters' performance.
- Comment 16 The two loans dropped from the report had significant underwriting issues. We removed the loans since Apreva has already signed indemnification agreements with HUD for the two loans. One indemnification agreement came out of findings from a HUD post endorsement file review, the other came out of a HUD Quality Assurance Division review of one of Apreva's Loan Correspondents.
- Comment 17 The report did not intend to provide the detailed information for the cases cited in Finding 1 due to the voluminous nature of the findings. As stated in the report, a detailed Appendix C will be furnished to both the FHA Commissioner and Apreva separately. Rather, we have provided examples of the deficiencies for three sample cases. The allegations in these cases are based on facts contained in the FHA Case Files and constitute violations of HUD/FHA requirements that affect the underlying loan's insurability. We selected these three loans because they represent the types of findings identified throughout our review. We are confident that the remaining files cited in Finding 1 are also ineligible for FHA insurance endorsement.

- Comment 18 The compensating factors listed by HUD are attempting to show the type of compensating factors that would be considered acceptable. The regulation specifically states that the compensating factor must be significant. In order to be significant it must be over and above a factor that would be required for a loan with ratios within the HUD guidelines. Our review indicated that the underwriter did not: (1) state compensating factors that would demonstrate the borrower's ability and willingness to make the loan payments with a higher percent of income than is customarily allowed, and (2) consider the totality of the circumstances in each of the cases cited in Finding 1 where qualifying ratios and compensating factors are questioned.
- Comment 19 We disagree. Our review consistently disclosed that the underwriters failed to base their decisions on the totality of the circumstances, and carefully weigh all aspects of the borrower's application prior to approving the loan for direct endorsement as elaborated in Comments 22 to 26.
- Comment 20 We only questioned income when the method used by the underwriter did not comply with HUD's requirements. Among other things, HUD requires that employment be documented for a two-year period, and that adequate documentation be obtained in order to make the determination of qualifying income. In most of the instances cited, the underwriter did not properly evaluate income and ensure that all required documentation was obtained.
- Apreva's response misinterprets HUD's requirements. The guidebook is not an authoritative document and thus cannot be used as if it were an official Handbook. The HUD-1 does not provide adequate documentation. If there are funds flowing to escrow from the seller and escrow funds are merely "netted" at closing, then the true source of the borrower's minimum down payment was the seller's funds, a prohibited source. HUD's requirements state that for loans where gift funds were provided for the downpayment, it must be able to trace the gift funds from the donor to the homebuyer. This requirement is applicable to both private individuals and non-profit donors. The important point for non-profit gifts is that the lender must verify (via a wire transfer document in most cases) that the funds for the gift came initially from the donor for the borrower's use **prior** to any funds having flowed from the seller (or some other acceptable source for the down payment) to the non-profit gift donor. There is no other way for the lender to satisfy the HUD/FHA requirement that the borrower's down payment did not come from an unacceptable source.
- Comment 22 The main issue for this loan is that a 2/1 buydown interest rate was used for qualification with high ratios and inadequate compensating factors. This fact is ignored in the written response. Mortgagee Letter 97-26 states that the department is concerned that lenders are offering buydowns without considering the possible "payment shock" associated with such financing arrangements. Ratios should rarely be exceeded, and consideration must be given to the borrower's ability to absorb increases in payments. The underwriter approved this loan with ratios that significantly exceeded HUD's guidelines and the

compensating factors not only did not address the borrower's ability to make the initial payments, it did not begin to address the borrower's ability to absorb future increases in mortgage payments. Further, the \$400 of overtime income referred to in the response was already included in the calculation the borrower's income and ratios and cannot be included as a compensating factor.

- Comment 23 The main issue for this loan is that Apreva did not properly analyze the borrower's **ability** to repay the mortgage. Apreva repeatedly stated in its response that the borrower had a stellar record of making its housing payment; however the housing payment was only \$32 per month because the borrower, a single mother, was on low income housing assistance. New housing costs were over 20 times more than the borrower was used to paying.
- Comment 24 With respect to the funds to close, the file contained a Verification of Deposit (VOD), that did not contain an average daily balance, and there were no bank statements in the FHA Case File. Exhibit E-4 of Apreva's response contained an updated VOD and a bank statement as of the date of closing. However, the bank statement provided by Apreva was not the borrower's; neither of the names on the joint bank account was the borrower's name.
- Comment 25 The main issue for this loan is that the underwriter did not ensure that documentation for loan qualification was complete and consistent with other file documents. Income was not adequately supported for a two-year period; the coborrower had only been employed for one and a half months at his current job and verification of his prior employment only covered a four month period. Further, the borrower did not have any documentation that the disability income would continue for three years or that his return to employment was guaranteed as required by HUD Handbook 4155.1 REV-1 CHG-1, 2-7 Q.
- Comment 26 Apreva stated that the borrowers provided acceptable letters of explanation and provided these letters as Exhibit F-3. The FHA Case File only included one of the two letters. Our review of both of these letters disclosed that the borrower did not prepare and sign the letter detailing his illness and injury. The signature on the case file letter did not match the signature on the other letter or the application and loan closing documents.
- Comment 27 In our opinion, the recommendations in OIG's report are appropriate given to the reported violations. The recommendations are actually based upon Apreva's pattern of general disregard of HUD/FHA requirements as outlined in all three findings of this report

We recognize that since Apreva hired the Corporate Underwriting Manager, policies and procedures have been written and it appears, based on our limited review, that some enhancements have been made. However, the default rates are still significantly higher than the average default rates for the Home Ownership Center. Furthermore, Apreva's ratings have not improved significantly during the

- past three quarters. Apreva received poor ratings over 90% of the time for post endorsement reviews of the underwriters' Mortgage Credit Analysis.
- Comment 28 The CEO states Apreva did not allow ineligible branches or non-employees to originate loans, and then states he recognizes that certain mistakes were made in connection with the offices, namely with respect to the exclusivity of employment. The non-exclusive loan officer employees are not true employees of Apreva as defined by HUD. If the loan officers are not exclusive (i.e. they are employed by a separate legal entity) and if the separate entity lacks HUD/FHA approval, then its mortgages constitute third party originations, which violate Departmental requirements per Mortgagee Letter 00-15.
- Comment 29 The CEO stated in his response that Apreva hired a Compliance and Branch Administrator in 2001 to review the structure and organization for each branch office to ensure the office was properly registered with HUD and operating in accordance with HUD/FHA guidelines. The Administrator's files contained a copy of Mortgagee Letter 00-15. As stated above, the Mortgagee Letter is quite clear in regards to separate legal entities.
- Comment 30 Apreva began the retail business primarily with loan officers that were employed by other non-approved mortgage companies in the Bellevue office, which was not registered with HUD/FHA for retail operations. Apreva began originating loans through the Bellevue office in October of 2000, over one year prior to registering the office with HUD.
- Comment 31 While the branches were registered with the state in 2000 through 2001, they were not registered with HUD until 2002 through 2003, long after Mortgagee Letter 00-15 was issued and after the Compliance and Branch Administrator was hired to ensure compliance with HUD's requirements. Further, our report also identified other separate legal entities that were not HUD-approved loan correspondents originating loans through Apreva.
- Comment 32 The issues of loan-level deficiencies and ineligible borrowers were not specifically identified in this finding. However, our analysis of Apreva's loan origination log disclosed that the loans identified as "Apreva Wholesale" that were originated using Apreva's identification number had a default rate of almost nine percent. Furthermore, four of the six early payment default loans in Finding 1 originated by Apreva were actually third party originations.
- **Comment 33** Apreva was not paying the expenses of all of the branch locations. See Comment 41.
- **Comment 34** The indemnification clause in question violates ML 00-15 because it is worded in such a way as to eliminate Apreva's responsibility for the actions of its contracted Loan Officers.

- **Comment 35** We have the evidence that indicates that these employees (see list on pages 52 and 53) were employed by or owned a mortgage company other than Apreva:
 - 1. Columbia Northwest Mortgage Inc.'s fax number was on the application.
 - 2. Apreva of Lewis County (located in Centralia, Washington) was on the application; however Apreva did not have a branch office in Centralia, Washington.
 - 3. Apreva Funding, Eugene Oregon, was on the loan application; however there is no branch office in Eugene Oregon.
 - 4. Apreva's loan origination log listed *Apreva CEO Dave Pederson as the Loan Officer*. However, the actual loan officer as identified in the loan file was not an Apreva employee, but worked for Columbia Northwest according to the application. Columbia Northwest is not a HUD-approved lender.
 - 5. Sage Home Loans was paid the origination fee before becoming a branch of Apreva. The mortgage company was also referred to as All Star Home Loans.
 - 6. The loan officer owned Apreva of Lewis County according to an interview with him. Apreva did not have a branch office in Centralia, Washington.
 - 7. This loan officer's personnel file listed him as being with J&L Mortgage Professionals. This Loan Officer was assigned to the Bellevue Branch Office but lived in Vancouver, Washington. Further, the Bellevue Office was not a registered HUD branch office when the loan was originated.
 - 8. Columbia Northwest Mortgage Inc. fax number was on the application. Further, the funding sheet stated that the originator was "Bellevue Wholesale".
 - 9. Direct Funding Group of Marysville, a non-HUD-approved lender, was on the loan application
 - 10. Mortgage Financing, a non-HUD-approved lender, was on the faxed loan documents.
 - 11. The loan officer owned Pacific Mutual according to his business card and Pacific Mutual was identified on the loan applications. See Comment 38 for more information.
 - 14 The loan officer worked for Prosperity Mortgage and owned SeaMist Industries/Sea Mist Mortgage LLC based on a resume and loan applications. See Comment 40 for more information
 - 15. This employee did not have a loan officer agreement on file with Apreva; however she worked for Pacific Mutual. See Comment 38 for more information.
 - 16. Pacific Mutual was identified on the loan applications. See Comment 38 for more information.
- **Comment 36** Finding 2 deals primarily with separate legal entity third party originations and the requirement that branch locations be approved by HUD. Both of these issues are clearly defined in Mortgagee Letter 00-15 and HUD Handbook 4060.1 REV-1.
- **Comment 37** After reviewing Apreva's response and the additional information provided, we are amending the report to exclude the Pacific Mutual Branch Office loans from

- Appendix E. The loans originated from the separate location that was not approved by HUD will remain in the report.
- Comment 38 The branch manager/loan officer that left Pacific Mutual formed his own mortgage company and incorporated it in August of 2002. Our review of loan files disclosed that loan origination fees were paid directly to the new corporate entity. The loan closed prior to March of 2003.
- Comment 39 The Apreva Northwest Branch location is not compliant with HUD's requirements. The branch is located in the basement of a home with no identification of the name of the branch. HUD Handbook 4060.1 REV-1 paragraph 2-16(a)(4) states that branch office facilities must be "... clearly identified to the public so that mortgagors will know, at all time (sic), exactly with which business entity they are doing business. This includes a business sign ..."
- Comment 40 HUD's requirements state that lenders, including Apreva, are responsible for the actions of their branches and employees. According to a resume in Apreva's SeaMist Industries file, the branch manager worked for Prosperity Mortgage from April 1999 through May of 2002; however he started originating loans through Apreva in October of 2000.
- **Comment 41** Apreva did not pay SeaMist operating expenses. The accounting system did not identify any SeaMist expenses nor did they provide any documentation to support this assertion.
- **Comment 42** Mortgagee Letter 94-39 states that "Mortgagees are permitted to utilize a satellite office(s) for processing streamline refinance mortgages only without regard to this 'location' requirement." The offices in question originated all types of loans, not just streamline refinances, and so the offices do not qualify for this exception.
- Comment 43 Apreva did not provide any evidence to support the assertion that the Pacific Mutual Mortgage office was located in an office that was separate and apart from any other entity. On the contrary, the office was located in a Real Estate Office building.
- Comment 44 The SeaMist Industries "satellite office" was not clearly identified to the public, and Apreva did not pay its operating expenses. The address for the branch is Loan Officer 13's personal residence located in a rural area on a private drive. There was no identification of SeaMist Industries or Apreva at his residence. Furthermore, when the branch office was approved it did not satisfy HUD requirements because Sea Mist did not have two employees nor was the office open to the public during normal business hours.
- Comment 45 SeaMist Industries and Sea Mist Mortgage LLC were always separate entities. Our review disclosed an early 2002 Apreva earnings statement showing a commission payment to Sea Mist Industries. The earnings statement contained

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the description "1099\$\$", indicating that Apreva paid commissions to Sea Mist Inc. as a contractor and did not pay the owner directly as a regular Apreva employee. Furthermore, our research of Sea Mist Industries disclosed that the company's primary business was "Business Services and Vacuum Cleaner Repair and Parts". When Sea Mist Industries became Sea Mist Mortgage, the Limited Liability Corporation was set up. Apreva's statement that Sea Mist Mortgage LLC is not the same entity as Apreva's branch, Sea Mist Mortgage, is not supported by any documentary evidence.

- **Comment 46** Per HUD's requirements, the method of payment does not determine whether or not an individual is an employee.
- **Comment 47** These Apreva "employees" were not just associated with the independent mortgage broker, they were employees and worked in the offices of these brokers.
- Comment 48 In our limited review of FHA case files, we actually identified eight cases where loan fees were paid directly to a separate entity rather than to Apreva. In one instance a loan that was supposed to be originated by the Pacific Mutual Mortgage branch office was actually originated by, and fees were paid to Lender Solutions Group, Inc. This company was formed by one of the branch managers of Pacific Mutual in late 2002.
- Comment 49 Eighteen of the 20 files we reviewed had serious deficiencies. Only two of the 18 loans were reported on in Finding 1. Of the remaining 16, four were paid in full and one was originated using the wrong mortgagee identification number and is included in Appendix H of this report. We are recommending that HUD seek indemnification on the remaining 11 loans reported on in this finding.
- Comment 50 As previously noted, Ms. Clayborn stated in an interview that no formal Quality Control Reviews were done prior to hiring the Corporate Underwriting Manager. Her experience was in the financing side of the industry, not in origination and underwriting. Apreva alleges that there are copies of reports for March, April and May 2001; however they did not provide any evidence to support the assertion.
- **Comment 51** Apreva states that they have located Quality Control reports for December 2001 and August through November of 2002; however no documents were provided to support the assertion.
- Comment 52 The Corporate Underwriting Manager stated in an interview that from November of 2002 through January of 2003 she was concentrating on implementation of corrective action for the deficiencies already identified, so she did not take the time to do Quality Control reports for this time period.
- **Comment 53** Apreva reviewed 54 percent of the loans required by HUD from June 2001 through April 2003.

- **Comment 54** Most of the changes noted were done from late 2002 through late 2003. This does not constitute timely corrective action.
- Comment 55 HUD Handbook 4060.1 REV-1, paragraph 6-1 (D)(5) states:

"Sponsors of Loan Correspondents are required to perform quality control reviews on loans purchased from each of their correspondents. This is not meant to be a substitute for the correspondent's own quality control. A Loan Correspondent may enter into a contractual arrangement with its Sponsor or some other entity to perform its quality control. The results of these reviews must be passed on to the management of the Loan Correspondent and appropriate action must be taken."

This clearly indicates that the results of all reviews performed by the Sponsor or a contractor must be passed on to the management of the Loan Correspondent.

Comment 56 The key issue is that HUD must know with whom it is doing business.

Mortgagee Letter 94-56 allowed approved Loan Correspondents to utilize the services of approved Sponsor lenders for processing FHA insured loans stating: "Under this option, the Loan Correspondent mortgagee must take the original application and conduct the face-to-face interview as required. The loan must close in the name of the Loan Correspondent. When requesting the FHA case number from the local HUD field office, the request must be made in the name of the Loan Correspondent, as is currently required..."

Mortgagee Letter 96-12 eliminated the requirement that a loan must close in the name of the Loan Correspondent but did not eliminate the requirement that the request for the FHA case number be made in the name of the Loan Correspondent. We clarified this in the report.

Apreva used its own identification number as the originator of 35 loans that were actually originated by its loan correspondents, and HUD was unaware of the identity of the actual originating lenders. It is important to note that Apreva CEO Dave Pederson is shown in Apreva's loan origination log as the Loan Officer for approximately half of these 35 loans.

- **Comment 57** The report did not take issue with Apreva closing loans originated by loan correspondents in Apreva's name.
- Comment 58 As stated in Comment 56, it is imperative that HUD/FHA know whom they are doing business with and that it was not an inadvertent error. We found evidence in Case File No. 569-0540546 that Apreva directed the loan correspondent to change file documents to reflect a mortgage company other than the one that was originating the mortgage. See Detailed Appendix C-08 (provided under separate cover) for more information.

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- **Comment 59** We agree that Apreva has implemented new policies and procedures for the reviews of loan correspondent's activities. However, these policies and procedures were not in place during the time of our audit and we have not reviewed them for compliance with HUD's requirements.
- Comment 60 The report did not intend to provide the detailed information for the cases cited in Finding 3 due to the voluminous nature of the findings. As stated in the report, a detailed Appendix G will be furnished to both the FHA Commissioner and Apreva separately. Rather, we have summarized the deficiencies in Appendix G. The allegations in these cases is based on facts contained in the FHA Case Files and constitute violations of HUD/FHA requirements that have an affect on the underlying loans' insurability.
- Comment 61 The Corporate Underwriting Manager informed us that she was taking a conservative approach due to the "horrible" underwriting that she was seeing in the case files. However, the results provided in Appendix G only include the issues where the underwriting was not performed in compliance with HUD/FHA requirements. We excluded those items that we noted were too conservative.

Summary of Underwriting and Origination Deficiencies

(Recommendation 1B. and 1C.)

FHA						
Case No.	A	В	C	D	E	F
561-7324721	X	X	X		X	X
561-7549790	X		X		X	
561-7343562	X	X	X			X
561-7309100	X	X	X		X	X
431-3600832	X	X	X	X		X
431-3559344	X		X		X	
431-3551311	X	X	X	X	X	X
569-0540546	X	X	X	X		X
431-3515212			X	X		X
561-7187129	X		X			
561-7365244			X	X		X
561-7189612	X	X	X			X
561-7182695	X	X	X		X	X
561-7286022	X	X	X	X	X	X
561-7280695	X	X	X	X		X
561-7473527	X	X			X	
561-7243033		X	X			
561-7182716		X	X			X
561-7284327	X	X		X		X
561-7525367	X		X	X	X	X
569-0522991	X		X			X
569-0485961			X	X		X
431-3703222	X	X				X
431-3684152	X	X	X	X		X
561-7285374			X	X		X
561-7458291	X	X	X	X		X
561-7321226		X	X	X		X
561-7231738			X	X	X	X
431-3581581	X	X	X			X
561-7355242	X			X	X	X
431-3633059	X	X	X			X
431-3729577			X	X	X	
431-3699469	X		X	X		
431-3635825	X	X			X	X
431-3503033	X	X	X	X		X
Total Deficiencies By Issue	26	22	30	19	13	28

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The above matrix shows a general pattern of disregard for FHA underwriting requirements for the 35 loans with early payment defaults. Of particular significance is that a pattern is prevalent in the critical elements that determine whether a loan will go into default and foreclosure: debt to income ratio, source of funds, and employment stability. (Detailed results of our review will be provided under separate cover.)

HUD requires the lender to verify information with as much care as would be used if entirely dependent on the property as security. When standard documentation does not provide enough information to support this decision, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or supplement the documentation submitted by the borrower. Chapter 2, Section 5 of HUD Handbook 4155.1 REV-4, *Mortgage Credit Analysis for Mortgage Insurance* states that the lender must establish that the borrower has the ability and willingness to repay the mortgage debt. Simply establishing that a loan transaction meets minimal standards does not necessarily constitute prudent underwriting. In addition, HUD requires the lender to review appraisals for inconsistent and otherwise unacceptable items prior to approving the loan. Our review consistently disclosed that the underwriters failed to base their decisions on the totality of the circumstances, and carefully weigh all aspects of the borrower's application prior to approving the loan for direct endorsement. The six areas in which we noted Apreva's deficiencies are:

A. Apreva failed to provide valid or sufficient compensating factors when HUD's benchmark debt to income ratios of 29 and 41 percent were exceeded on FHA loans that were manually underwritten.

Apreva approved loans with excessive qualifying ratios without adequate compensating factors for 26 of the loans reviewed. Per HUD Handbook 4155.1 REV-4 CHG-1, Paragraphs 2-12 and 2-13, the borrower's mortgage payment to effective income and total fixed payment to effective income ratios should not exceed 29 percent and 41 percent respectively, unless the mortgagee identifies compensating factors that could justify exceeding these ratios.

Compensating factors include:

- The borrower has successfully demonstrated the ability to pay the new housing expenses;
- The borrower makes a large downpayment;
- The borrower has a conservative attitude toward the use of credit and an ability to save;
- Previous credit history shows an ability to devote a greater portion of income to housing;
- The borrower receives compensation not reflected in income, but directly affecting the ability to pay the mortgage;
- There is only a minimal increase in the borrower's housing expense;

- The borrower has substantial cash reserves after closing;
- The borrower has substantial non-taxable income (if no adjustment for the ratios); or
- The borrower has potential for increased earnings due to job training or education.

Our review disclosed the remarks on the Mortgage Credit Analysis Worksheets (MCAW) provided borrower qualification information rather than compensating factors to justify high ratios as required by HUD/FHA.

Additionally, some of the loans with high ratios were also buydown interest rate loans. Mortgagee Letter 97-26, Qualifying Ratios, Compensating Factors, and Buydowns states that the department is concerned that lenders are offering buydowns without considering the possible "payment shock" associated with such financing arrangements. Ratios should rarely be exceeded and consideration must be given to the borrower's ability to absorb increases in payments. Our review disclosed that the underwriter approved the high ratio loans without any consideration of how the borrower would absorb the payment increases. The total fixed payment to effective income ratios ranged from 43.4 to 47.5 percent.

Furthermore, Apreva's underwriters understated debt-to-income ratios for most of the loans reviewed. Our review found that Apreva often included overstated and/or unsupported income (see B below). Additionally, Apreva did not always ensure that all the borrower's liabilities were included in the calculation of the ratios as required by HUD Handbook 4155.1 REV-4 CHG-1, Paragraph 2-11. Liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations extending ten months or more. Debts lasting less than ten months must also be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing. This is especially true if the borrower will have limited or no assets after the loan closes. Our review disclosed Apreva often excluded debts lasting ten months or less when the borrowers had high ratios and limited cash reserves contrary to HUD requirements. These omissions often caused a significant effect on the debt to income ratios used to qualify the borrowers.

B. Apreva failed to document the stability of income in accordance with HUD/FHA requirements.

Apreva did not verify and/or compute income as required by HUD for 22 of the loans reviewed. Per Chapter 2, Section 2 of HUD Handbook 4155.1 REV-4 CHG-1, the anticipated amount of income, and likelihood of its continuance, must be established to determine the borrower's capacity to repay the mortgage debt. Income from any source that cannot be verified, is not stable, or will not continue may not be used in calculating the borrower's income ratios. Mortgagees must obtain and verify information with as much care as would be used if entirely dependent on the property as security.

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Our review found the following areas of non-compliance:

- Apreva did not ensure that borrower's income was adequately supported. HUD Handbook 4155.1 REV-4 CHG-1 Paragraph 3-1E provides the requirements for income verification. Generally, a Verification of Employment (VOE) for the past two years of employment and a copy of the borrower's most recent pay stub must be provided to support income. Alternative documentation can be used subject to the provisions in the Handbook. Our review disclosed Apreva did not always require adequate documentation of income used in the ratio calculations
- Apreva overstated overtime and/or bonus income. Per HUD Handbook 4155.1 REV-4 CHG-1, Paragraph 2-7A, both overtime and bonus income may be used to qualify if the borrower has received such income for approximately two years and it's likely to continue. The lender must use an average of bonus and/or overtime income for the past two years. In addition, the employment verification must not state categorically that such income is not likely to continue. Our review disclosed Apreva included overtime when it wasn't adequately supported or wasn't likely to continue.
- Apreva did not ensure that sufficient documentation was provided for inclusion of child support payments. HUD Handbook 4155.1 REV-4 CHG-1 Paragraph 2-7F, states that child support payments may be considered as effective if such payments are likely to be consistently received for approximately the first three years of the mortgage. The borrower must provide a copy of the divorce decree, legal separation agreement, or voluntary payment agreement, and evidence that payments have been received during the last twelve months. Our review disclosed Apreva included child support that wasn't adequately documented. In such cases, the underwriter should have requested additional support from the respective loan officer prior to including the income in debt to income ratio calculations.

C. Apreva failed to properly verify the source of funds used for the downpayment and/or closing costs.

Apreva did not ensure that the borrower had sufficient funds to close the loan for 30 of the loans reviewed. HUD Handbook 4155.1 Paragraph 2-10, states that the cash investment in the property as well as the source of these funds must be verified. Specifically:

- Apreva did not adequately verify funds. HUD Handbook 4155.1 REV-4 CHG-1, Paragraph 3-1F, provides that along with a verification of deposit, the mortgagee must obtain a current bank statement as of the application date. As an alternative to obtaining a verification of deposit, the mortgagee may choose to obtain the borrower's original bank statements for the most recent three month period or most recent two month period if the statements include beginning and ending balances. Our review disclosed that the underwriter did not ensure that the documentation of funds was adequate prior to underwriting the loan.
- Apreva did not provide sufficient evidence of the earnest money deposit. HUD Handbook 4155.1 REV-4 CHG-1, Paragraph 2-10A, states that if the earnest money deposit appears

excessive based on the borrower's savings history, the deposit amount and the source of funds must be verified. Documentation includes a copy of the borrower's cancelled check or a certification from the deposit holder acknowledging receipt of funds, and separate evidence of the source of funds, including a verification of deposit or bank statement showing that the average balance at the time the deposit was made was sufficient to have included the earnest money deposit. Our review disclosed that the underwriter did not obtain documentation of the earnest money, even though the borrower's bank balances were not sufficient to cover the earnest money amount.

- Apreva did not obtain an explanation of the source of funds for large increases in bank accounts. HUD Handbook 4155.1 REV-4 CHG-1, Paragraph 2-10B, provides that if there is a large increase in a bank account amount, the mortgagee must obtain an explanation and evidence of the source of funds from the borrower.
- Apreva did not obtain all required evidence for the sale of personal property. HUD Handbook 4155.1 REV-4 CHG-1, Paragraph 2-10G, states that if the borrower intends to sell personal property to obtain funds required for closing, in addition to conclusive evidence the items have been sold, the borrower must provide a satisfactory estimate of their worth by submitting a separate written appraisal by a qualified appraiser with no financial interest in the loan transaction. Only the lesser of this estimate of value or the actual sales price is considered as assets to close. Our review disclosed that the underwriter did not ensure that a separate written appraisal was obtained for the assets sold.
- Apreva did not ensure that gift letters contained all of the required information. In accordance with HUD Handbook 4155.1 REV-4 CHG-1, Paragraph 2-10C, gift letters must show the donor's name, address, telephone number, and relationship to the borrower.
- Apreva did not adequately verify the source of the gift funds. Per Mortgagee Letter 00-28, "If the gift funds are in the homebuyer's account: The lender must document the transfer of the funds from the donor to the homebuyer by obtaining a copy of the canceled check or other withdrawal document showing the withdrawal is from the donor's personal account, along with the homebuyer's deposit slip or bank statement that shows the deposit." Our review disclosed that Apreva did not always ensure that the documentation obtained actually satisfied HUD's requirements.
- Apreva did not provide adequate evidence for the borrower's gift from a Downpayment Assistance Program. Per Mortgagee Letter 00-28, the lender must provide evidence that non-profit gift funds are received into escrow before the seller's donation is provided to the non-profit organization. The source and the transfer of gift funds from the donor to the homebuyer must be adequately documented. When the transfer of the gift funds occurs at closing, the lender remains responsible for obtaining verification that the closing agent received the gift funds directly from the donor and were not provided directly or indirectly by the seller, real estate agent, builder, or any other entity with an interest in the sales transaction. Our review disclosed that the evidence of wire transfer was not included in the loan file.

D. Apreva failed to ensure compliance with HUD/FHA credit requirements.

Apreva did not comply with HUD's credit requirements for 20 of the loans reviewed. Specifically:

- Apreva did not ensure that an adequate explanation was obtained for derogatory credit. Per HUD Handbook 4155.1, REV-4 CHG-1, Paragraph 2-3, if there are major indications of derogatory credit problems, a sufficient written explanation from the borrower is required. Major indications of derogatory credit include judgments and collections, and any other recent credit problems. The borrower's explanation must make sense and be consistent with other credit information in the file. Our review disclosed that Apreva did not always require explanations of derogatory credit and did not always ensure that the information was credible and consistent with other file documentation.
- Apreva did not properly evaluate the borrowers' prior rental or mortgage payment history.
 Per HUD Handbook 4155.1 REV-4 CHG-1, Paragraph 2-3A, the payment history of the borrower's housing obligations is of significant importance in evaluating credit. The underwriter must consider the borrower's payment history in their credit analysis. Our review disclosed Apreva did not always obtain the borrower's prior housing payment history.
- Apreva did not require sufficient explanations from the borrower for undisclosed debts and recent inquiries on the credit report. Per HUD Handbook 4155.1 REV-4 CHG-1, Paragraph 2-3B, the lender must ensure that no additional debt was incurred in order to obtain the cash investment. The borrower must explain all inquiries shown on the credit report. In addition, the borrower must provide a satisfactory explanation to account for the omission of significant debt. Our review disclosed Apreva did not always require explanations from the borrowers for undisclosed debts and credit inquiries. Specifically we noted the underwriter did not always address automatic payroll and bank account withdrawals, indicators of child support obligations, and/or past due tax obligations.

E. Apreva failed to review appraisals in compliance with HUD/FHA requirements and/or resolve appraisal irregularities.

Apreva did not adequately review appraisals for unreasonable items for 13 of the files reviewed. HUD Handbook 4150.1 REV-1, Paragraph 9-2, requires the underwriter or other reviewer to review each critical area of the appraisal for anything that appears unreasonable. If the reviewer notes any areas that are inconsistent or otherwise unacceptable, the report needs to be returned to the appraiser for correction, or the reviewer can modify or amend the report according to HUD valuation policy.

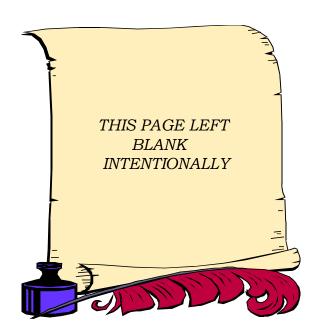
F. Apreva failed to clarify and/or adequately document important file discrepancies.

Apreva failed to resolve discrepancies in file documentation and/or made misstatements on the Mortgage Credit Analysis Worksheet (MCAW) for 28 of the loans reviewed.

Lenders are required to review file documentation to ensure that the information is consistent with the borrower's application and other file documents. Our review disclosed numerous discrepancies that should have been addressed by the underwriter, such as differences in borrower's name and age, bank account numbers, and number of dependents.

Furthermore, our review disclosed that the underwriter's remarks on the MCAW were often unsupported by file documentation. For example, the underwriter often stated that there was no derogatory credit in the past year; however, the file contained documentation detailing recent past due accounts, collection accounts and/or bank charges for lack of funds. We also noted that the underwriter made errors in the mortgage amount, appraised value, gift amount, gift source and/or sales price and related ratios.

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Prohibited Third Party Originations Columbia Northwest Mortgage Inc.

(Recommendation 2A.)

As discussed in Finding Number 2, the loans originated by the owner of Columbia Northwest Mortgage, Inc. (CNM) and seven of its loan officers constitute prohibited third party originations because the owner and loan officers (1) were not employed exclusively by Apreva, (2) were located in a separate office that was not an approved branch, and (3) signed agreements that are contrary to HUD requirements. In addition, loan origination fees were paid directly to CNM on two of the loans reviewed. CNM originated 58 loans as detailed below:

Loans that are currently at risk (Six loans)

FHA Case	Endorsement	Mortgage	Loan Status
Number	Date	Amount *	
561-7330409	10/18/2001	\$ 136,228	Conveyed to Insurer
561-7291725	7/31/2001	145,432	Conveyed to Insurer
561-7243482	6/7/2001	151,541	Delinquent
561-7358856	10/31/2001	122,032	Repayment
561-7366280	10/31/2001	104,362	Conveyed to Insurer
561-7540495	7/2/2002	132,914	Conveyed to Insurer
Total Value of Loa	ans Currently at Risk	\$ 792,509	

^{*}Original loan amount or loan amount for the loans refinanced by Apreva.

Loans that are current or paid in full. (52 loans including refinances)

FHA Case	Endorsement	FHA Case	Endorsement	FHA Case	Endorsement
Number	Date	Number	Date	Number	Date
431-3561672	9/5/2001	561-7300153	4/4/2002	561-7431253	12/20/2001
561-7219591	5/29/2001	561-7303613	8/1/2001	561-7433391	1/30/2002
561-7225506	6/4/2001	561-7317924	12/4/2001	561-7440731	1/4/2002
561-7226280	9/10/2001	561-7319721	10/18/2001	561-7450666	1/23/2002
561-7228801	6/6/2001	561-7330001	9/27/2001	561-7461987	1/29/2002
561-7229576	6/2/2001	561-7341141	10/18/2001	561-7475435	3/15/2002
561-7238503	5/22/2001	561-7354224	10/3/2001	561-7493921	3/26/2002
561-7242753	10/12/2001	561-7358436	10/13/2001	561-7494904	4/10/2002
561-7243499	7/3/2001	561-7366006	10/25/2001	561-7500746	4/15/2002
561-7249410	8/20/2001	561-7371659	11/2/2001	561-7507219	2/25/2003
561-7256303	9/6/2001	561-7375116	11/9/2001	561-7516099	5/17/2002
561-7260497	7/6/2001	561-7379007	11/6/2001	561-7518372	5/14/2002
561-7264707	6/29/2001	561-7379039	10/29/2001	561-7522331	6/5/2002
561-7266579	9/5/2001	561-7380588	11/1/2001	561-7531799	5/28/2002
561-7272568	8/23/2001	561-7385772	11/20/2001	561-7630027	12/3/2002

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	FHA Case	Endorsement	FHA Case	Endorsement	FHA Case	Endorsement
	Number	Date	Number	Date	Number	Date
5	61-7272857	10/19/2001	561-7420708	1/11/2002	562-1771074	7/10/2001
5	61-7286357	8/2/2001	561-7421069	2/6/2002		
5	61-7291891	8/20/2001	561-7424007	12/19/2001		

Prohibited Third Party Originations Pacific Mutual Mortgage Ineligible Loan Officer

(Recommendation 2A.)

As discussed in Finding Number 2, the loans originated by the two owners of Pacific Mutual (PM) and its loan officer constitute prohibited third party originations because the owners and loan officer (1) were located in a separate office that was not an approved branch, and (2) signed agreements that are contrary to HUD requirements. PM originated 57 loans prior to getting branch approval as detailed below:

Loans currently at risk (nine loans)

FHA Case	Endorsement	Refinanced	Mortgage	Loan Status
Number	Date	Case Number	Amount*	
		(if applicable)		
561-7260740	6/26/2001	561-782579	\$ 162,096	Repayment
561-7269660	9/20/2001		150,143	Modification
561-7301720	8/3/2001		125,260	Reinstated, Now Current
561-7324721	9/7/2002		See Note	Conveyed to Insurer
			Below	
561-7329583	10/19/2001		106,232	Commence Foreclosure
561-7336135	5/6/2002		132,914	Reinstated, Now Current
561-7368059	10/2/2001		136,360	Reinstated, Now Current
561-7412730	12/12/2001		111,254	Foreclosure Started
561-7424427	12/19/2001		123,068	Foreclosure Complete
Total Value of	Loans Currently	at Risk	\$1,047,327	

^{*}Original loan amount or loan amount for the loans refinanced by Apreva.

Note: Loan has underwriting issues – see Appendices A and C for details

Loans current or paid in full. (48 loans including refinances)

FHA Case	Endorsement	FHA Case	Endorsement	FHA Case	Endorsement
Number	Date	Number	Date	Number	Date
561-7149613	10/1/2001	561-7282492	10/3/2001	561-7359034	10/1/2001
561-7183813	3/30/2001	561-7292629	8/18/2001	561-7370177	10/19/2001
561-7195052	5/3/2001	561-7293341	7/20/2001	561-7383170	11/6/2001
561-7204075	5/21/2001	561-7293959	7/3/2001	561-7383339	11/16/2001
561-7209384	9/8/2001	561-7295279	9/19/2001	561-7404711	11/20/2001
561-7214700	6/5/2001	561-7295307	9/4/2001	561-7414203	12/21/2001
561-7216202	7/18/2001	561-7302387	12/26/2001	561-7419360	12/20/2001
561-7216254	6/13/2001	561-7303738	8/3/2001	561-7428730	1/30/2002

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FHA Case	Endorsement	FHA Case	Endorsement	FHA Case	Endorsement
Number	Date	Number	Date	Number	Date
561-7218097	8/17/2001	561-7303796	9/5/2001	561-7455713	2/6/2002
561-7220866	6/19/2001	561-7303898	8/17/2001	561-7456646	1/23/2002
561-7224874	5/24/2001	561-7312066	9/8/2001	561-7473904	3/8/2002
561-7227421	7/6/2001	561-7319151	8/7/2001	561-7475458	2/27/2002
561-7237362	5/30/2001	561-7319838	8/3/2001	561-7488480	4/2/2002
561-7242493	6/14/2001	561-7323370	2/13/2002	561-7494536	4/18/2002
561-7244182	6/12/2001	561-7334003	10/4/2001		
561-7249246	9/24/2001	561-7347695	10/3/2001		
561-7250585	10/17/2001	561-7424984	12/20/2001		

Prohibited Third Party Originations Sea Mist Industries

Recommendation 2A.

As discussed in Finding Number 2, the loans originated by the owner of Sea Mist Industries (SMI) constitute prohibited third party originations because the owner (1) was not employed exclusively by Apreva, (2) paid its own expenses, and (3) signed an agreement that is contrary to HUD requirements. SMI originated 35 loans as detailed below:

Loans currently at risk. (Three loans)

FHA Case Number	Endorsement Date	Mortgage Amount*	Loan Status
561-7205983	7/13/2001	\$ 93,532	Partial Restatement,
			Now Current
561-7309100	8/21/2001	See Note	Reinstated, Now Current
		Below	
561-7321386	9/19/2001	153,097	Reinstated, Now Current
Total Value of Loans C	urrently at Risk	\$ 246,629	

^{*}Original loan amount or loan amount for the loans refinanced by Apreva.

Note: Loan has underwriting issues – see Appendices A and C for details

Loans current or paid in full. (32 loans including refinances)

FHA Case	Endorsement	FHA Case	Endorsement	FHA Case	Endorsement
Number	Date	Number	Date	Number	Date
561-7188929	4/23/2001	561-7414810	12/4/2001	561-7498436	4/22/2002
561-7203720	5/14/2001	561-7441267	2/6/2002	561-7499346	4/29/2002
561-7205738	5/29/2001	561-7444937	1/11/2002	561-7504662	5/14/2002
561-7205800	5/29/2001	561-7445232	1/31/2002	561-7511476	5/9/2002
561-7224924	7/9/2001	561-7458988	2/25/2002	561-7531645	6/21/2002
561-7236691	6/22/2001	561-7460033	2/20/2002	561-7532736	6/14/2002
561-7311973	4/1/2002	561-7463539	2/7/2002	561-7534658	7/2/2002
561-7319709	11/1/2001	561-7473825	2/28/2002	561-7539395	7/16/2002
561-7321249	9/27/2001	561-7474315	4/4/2002	561-7544690	7/1/2002
561-7358465	10/19/2001	561-7475470	3/11/2002	561-7551866	7/18/2002
561-7385402	10/24/2001	561-7484857	4/15/2002		

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Prohibited Third Party Originations Qualified Residential Inc.

(Recommendation 2A.)

As discussed in Finding Number 2, the loans originated by the individuals affiliated with Qualified Residential Inc. (QR) constitute prohibited third party originations because these individuals (1) were not employed exclusively by Apreva, (2) were located in a separate office that was not an approved branch, and (3) signed agreements that are contrary to HUD requirements. QR originated 18 loans as detailed below:

Loans currently at risk (Five loans)

FHA Case	Endorsement	Refinanced	Mortgage	Loan Status
Number	Date	Case Number	Amount *	
		(if applicable)		
431-3548682	6/29/2001	431-3772450	\$ 167,944	Forbearance
		then to		
		431-3849327		
431-3582325	11/27/2001		133,726	Reinstated, Now Current
431-3592208	8/13/2001		131,899	Preforeclosure Sale Complete
431-3583807	7/24/2001		134,391	Conveyed to Insurer
431-3600832	10/3/2001		See Note	Reinstated, Now Current
			Below	
Total Value of	Loans Currently	at Risk	\$ 567,960	

^{*}Original loan amount or loan amount for the loans refinanced by Apreva.

Note: Loan has underwriting issues – see Appendices A and C for details

Loans current or paid in full. (13 loans including refinances)

FHA Case	Endorsement	FHA Case	Endorsement
Number	Date	Number	Date
431-3529421	8/16/2001	431-3625913	10/2/2001
431-3551340	6/21/2001	431-3639215	11/9/2001
431-3557077	10/10/2001	431-3686879	3/21/2002
431-3567935	9/6/2001	431-3694222	2/25/2002
431-3577354	10/1/2001	431-3694898	1/28/2002
431-3612780	9/26/2001	431-3718075	3/26/2002
431-3617900	10/3/2001		

Prohibited Third Party Originations Miscellaneous

(Recommendation 2A.)

The loans originated by the individuals affiliated with the companies listed below constitute prohibited third party originations because these individuals (1) were not employed exclusively by Apreva, (2) were located in a separate offices that were not approved branches, and/or (3) signed agreements that are contrary to HUD requirements. These individuals originated 66 loans as detailed below:

Loans currently at risk. (6 Loans)

FHA Case	Other Mortgage	Endorsement	Mortgage	Loan Status
Number	Company	Date	Amount *	
431-3559344	Goodlin Financial	8/1/2001	See Note	Commence
			Below	Foreclosure
561-7272046	Town Financial Services Inc.	8/28/2001	188,049	Conveyed to
				Insurer
561-7280491	CFG Mortgage	9/21/2001	213,099	Partial
				Reinstatement,
				Now Current
561-7343562	Mortgage Financing	9/27/2001	See Note	Conveyed to
			Below	Insurer
561-7559042	All Fund, IncAmerifund	7/16/2002	142,710	Repayment
561-7689958	Lending Solutions Group, Inc.	2/24/2003	115,192	Repayment
Total Value of	Loans Currently at Risk		\$ 659,050	

^{*}Original loan amount or loan amount for the loans refinanced by Apreva.

Note: Loan has underwriting issues – see Appendices A and C for details

Loans current or paid in full (60 Loans includes refinances)

FHA Case	Endorsement	Mortgage Company
Number	Date	
561-7633601	12/16/2002	All Fund IncAmerifund
431-3805276	10/17/2002	Apreva Mortgage of Lewis County
561-7311582	7/25/2001	Apreva Mortgage of Lewis County
561-7329648	8/15/2001	Apreva Mortgage of Lewis County
561-7429322	2/6/2002	Apreva Mortgage of Lewis County
561-7465517	2/6/2002	Apreva Mortgage of Lewis County
561-7478822	3/15/2002	Apreva Mortgage of Lewis County
561-7480595	3/15/2002	Apreva Mortgage of Lewis County
561-7483629	3/13/2002	Apreva Mortgage of Lewis County
561-7484495	3/15/2002	Apreva Mortgage of Lewis County

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FHA Case Number	Endorsement Date	Mortgage Company
561-7552817	7/2/2002	Apreva Mortgage of Lewis County
561-7636751	11/27/2002	Apreva Mortgage of Lewis County
561-7684792	2/19/2003	Apreva Mortgage of Lewis County
569-0532953	3/8/2002	Apreva Mortgage of Lewis County
561-7373319	11/21/2001	CFG Mortgage
561-7383401	11/16/2001	CFG Mortgage
561-7421210	12/14/2001	CFG Mortgage
561-7444415	1/29/2002	CFG Mortgage
561-7473781	3/6/2002	CFG Mortgage
561-7503769	4/26/2002	CFG Mortgage
561-7519854	5/14/2002	CFG Mortgage
561-7532765	6/13/2002	CFG Mortgage
561-7637728	11/19/2002	CFG Mortgage
431-3603947	11/13/2001	First ExecMortgage Co.
431-3644161	11/7/2001	First ExecMortgage Co.
431-3652035	11/9/2001	First ExecMortgage Co.
431-3509570	4/27/2001	First ExecMortgage Co.
431-3524578	9/20/2001	First ExecMortgage Co.
431-3680059	1/9/2002	First ExecMortgage Co.
431-3693805	2/1/2002	First ExecMortgage Co.
431-3676422	12/10/2001	Goodlin Financial
431-3637073	11/9/2001	Goodlin Financial
431-3620061	10/31/2001	Goodlin Financial
431-3553052	6/27/2001	Hill Valley Financial
431-3659584	11/27/2001	Hill Valley Financial
431-3682390	2/27/2002	Hill Valley Financial
569-0520013	10/19/2001	J&L Mortgage Professionals
561-7629426	11/08/2002	Lending Solutions Group, Inc.
561-7630981	11/08/2002	Lending Solutions Group, Inc.
561-7647634	12/16/2002	Lending Solutions Group, Inc.
561-7677365	1/24/2003	Lending Solutions Group, Inc.
431-3679514	12/28/2001	Marquee Mortgage
561-7505088	5/2/2002	Nova Star Home Mortgage
561-7308481	8/07/2001	Pacific Guarantee Mortgage Corp.
561-7591083	10/28/2002	Puget Sound Mortgage, LLC
561-7675000	1/21/2003	Pacific Guarantee Mortgage Corp
561-7715894	2/18/2003	Sage Home Loans
431-3552772	6/8/2001	Security Mortgage
561-7235486	10/18/2001	Town Financial Services, Inc.
561-7314543	8/03/2001	Town Financial Services, Inc.
561-7356487	11/14/2001	Town Financial Services, Inc.
561-7358906	11/21/2001	Town Financial Services, Inc.

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FHA Case	Endorsement	Mortgage Company
Number	Date	
561-7364086	10/12/2001	Town Financial Services, Inc.
561-7394024	11/27/2001	Town Financial Services, Inc.
561-7401239	11/20/2001	Town Financial Services, Inc.
561-7432691	2/28/2002	Town Financial Services, Inc.
561-7436720	1/30/2002	Town Financial Services, Inc.
561-7454117	1/23/2002	Town Financial Services, Inc.
561-7473282	3/15/2002	Town Financial Services, Inc.
561-7600179	9/16/2002	Town Financial Services, Inc.

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Prohibited Third Party Originations Ineligible Loan Officers

(Recommendation 2A.)

The loans originated by three Apreva loan officers constitute prohibited third party originations because the loan officers signed agreements that are contrary to HUD requirements. The three individuals originated seven loans as detailed below:

Loans current or paid in full. (7 Loans)

FHA Case	Endorsement	Location of
Number	Date	Loan Officer
431-3721016	3/15/2002	Eugene, OR
561-7162894	4/10/2001	Marysville, WA
561-7180881	1/26/2001	Marysville, WA
561-7200861	5/24/2001	Marysville, WA
561-7224868	5/26/2001	Marysville, WA
561-7228797	6/22/2001	Marysville, WA
561-7449553	1/25/2002	Bellevue, WA

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Ineligible Branch Office Sea Mist Mortgage, LLC

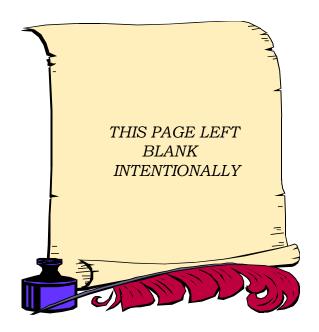
(Recommendation 2A.)

As discussed in detail in Finding 2, the branch doing business as Sea Mist Mortgage, LLC is a separate legal entity and therefore does not meet HUD requirements. Sea Mist Mortgage originated 20 loans as detailed below:

Loans current or paid in full (20 loans including refinances)

FHA Case	Endorsement	FHA Case	Endorsement	FHA Case	Endorsement
Number	Date	Number	Date	Number	Date
561-7546128	8/13/2002	561-7668045	1/31/2003	561-7668232	1/23/2003
561-7585319	9/11/2002	561-7668080	2/3/2003	561-7668249	1/23/2003
561-7587066	10/17/2002	561-7668118	1/23/2003	561-7668255	1/28/2003
561-7607647	10/11/2002	561-7668124	1/24/2003	561-7668392	1/22/2003
561-7637690	12/6/2002	561-7668153	1/31/2003	561-7675834	2/26/2003
561-7642626	1/9/2003	561-7668182	2/10/2003	561-7687645	1/22/2003
561-7668000	1/21/2003	561-7668226	1/24/2003		

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Apreva Loans With Improper Certifications

(Recommendation 2B.)

561-7456646

			Nature of Improper Certification (Described below)		on
	Endorsemen				
FHA Case	t				
Number	Date	Originating Mortgagee	A	В	C
431-3805276	10/17/2002	Apreva Mortgage of Lewis County	Y	Y	X
561-7311582	7/25/2001	Apreva Mortgage of Lewis County	X	X	ND
561-7636751	11/27/2002	Apreva Mortgage of Lewis County	Y	Y	ND
561-7280491	9/21/2001	CFG Mortgage	X	X	X
561-7444415	1/29/2002	CFG Mortgage	X	NS	ND
561-7153601	8/28/2001	Columbia NorthWest Mortgage, Inc.	X	X	ND
561-7264707	6/29/2001	Columbia NorthWest Mortgage, Inc.	X	NS	ND
561-7272568	8/23/2001	Columbia NorthWest Mortgage, Inc.	X	X	ND
561-7330409	10/18/2001	Columbia NorthWest Mortgage, Inc.	X	Y	ND
561-7379007	11/6/2001	Columbia NorthWest Mortgage, Inc.	Y	Y	X
561-7433391	1/30/2002	Columbia NorthWest Mortgage, Inc.	Y	Y	X
561-7450666	1/23/2002	Columbia NorthWest Mortgage, Inc.	Y	Y	X
561-7461987	1/29/2002	Columbia NorthWest Mortgage, Inc.	Y	Y	X
561-7493921	3/26/2002	Columbia NorthWest Mortgage, Inc.	X	Y	X
561-7507219	2/25/2003	Columbia NorthWest Mortgage, Inc.	NS	NS	ND
561-7518372	5/14/2002	Columbia NorthWest Mortgage, Inc.	X	NS	ND
561-7673153	1/21/2003	Columbia NorthWest Mortgage, Inc.	Y	Y	X
431-3652035	11/9/2001	First Exec Mortgage Co.	X	X	X
431-3501787	5/31/2001	First Exec Mortgage Co.	X	X	X
431-3559344	8/1/2001	Goodlin Financial	X	X	X
431-3620061	10/31/2001	Goodlin Financial	X	Y	ND
431-3553052	6/27/2001	Hill Valley Financial Services	X	X	X
431-3601809	8/14/2001	Hill Valley Financial Services	X	X	X
431-3721016	3/15/2002	Independent Loan Officer	X	X	
		Eugene, Oregon			
561-7228797	6/22/2001	Independent Loan Officer	X	X	ND
		Marysville, Washington			
561-7449553	1/25/2002	Independent Loan Officer	NS	NS	ND
		Bellevue, Washington			
569-0520013	11/7/2001	J and L Mortgage Professionals	Y	Y	ND
561-7689958	2/24/2003	Lending Solutions Group Inc	X	X	X
431-3679514	12/28/2001	Marquee Mortgage	X	X	ND
561-7343562	9/27/2001	Mortgage Financing	X	X	X
561-7324721	9/7/2001	Pacific Mutual	X	X	X

Pacific Mutual

1/23/2002

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X

			Nature of Improper Certification (Described below)		
FHA Case	Endorsemen				
Number	t Date	Originating Mortgagee	A	В	C
561-7473904	3/8/2002	Pacific Mutual	Y	Y	X
561-7368059	10/2/2001	Pacific Mutual - University Place	Y	Y	X
561-7424427	12/19/2001	Pacific Mutual - University Place	X	X	X
431-3582325	11/27/2001	Qualified Residential Mortgage, Inc.	NS	NS	ND
431-3592208	8/13/2001	Qualified Residential Mortgage, Inc.	NS	NS	ND
431-3600832	10/3/2001	Qualified Residential Mortgage, Inc.	X	X	X
431-3625913	10/2/2001	Qualified Residential Mortgage, Inc.	Y	Y	X
431-3686879	3/21/2002	Qualified Residential Mortgage, Inc.	Y	Y	X
431-3694898	1/28/2002	Qualified Residential Mortgage, Inc.	Y	Y	X
431-3718075	3/26/2002	Qualified Residential Mortgage, Inc.	X	X	X
561-7715894	2/18/2003	Sage Home Loans	X	X	X
561-7309100	8/21/2001	Sea Mist Industries	Y	Y	
561-7498436	4/22/2002	Sea Mist Industries	X	NS	ND
561-7675834	2/26/03	Sea Mist Mortgage, LLC	X	NS	ND
431-3552772	6/8/2001	Security Mortgage	X	X	ND
561-7272046	8/28/2001	Town Financial Services, Inc.	X	NS	ND
561-7454117	1/23/2002	Town Financial Services, Inc.	X	X	ND

Nature of Improper Certification on the URLA

- A Part II C certification by non-employee loan officer
- B Page 4 certification by non-employee loan officer
- C Page 4 certification dated prior to final settlement date
- X Indicates violation of item A, B, or C, as applicable.
- Y Indicates violation of item A, B, or C, as applicable, but was signed by Apreva employee on behalf of the loan officer.

Acronyms

- NS Application obtained from Apreva's case file was not signed.
- ND Application obtained from Apreva's case file was not dated.

Summary of Underwriting Deficiencies Noted During Our Review of Apreva's Quality Control Reviews

(Recommendation 3A. and 3B.)

		Un	derwritin	g Deficien	cy*	
FHACase No.	A	В	C	D	E	F
431-3625726		X				X
561-7475697			X			
569-0532591	X	X	X	X		
431-3719006	X	X	X			X
431-3731876		X				
561-7498436		X	X	X		
431-3659062		X				
431-3747456	X	X	X			
561-7540790		X	X	X		
561-7714083			X		X	X
431-3880566	X	X				
Total For Each Deficiency	4	9	7	3	1	5

^{*} See Appendix C for related regulations.

We performed a limited review of 20 loans selected by Apreva's Quality Control (QC) reviewer between June 2001 and March 2003. In 18 of the loans reviewed, Apreva did not exercise prudent judgment and/or follow the underwriting procedures as outlined in HUD's Mortgagee Handbooks (See Appendix C). We also noted during our review that the QC reviewer did not disclose all of the major underwriting deficiencies. Seven of the loans with serious underwriting deficiencies are reported in other sections of the report. The following is a summary of our review of the remaining 11 case files. Detailed results of these FHA loan files will be furnished to your office under separate cover.

A. Apreva failed to provide valid or sufficient compensating factors when HUD's benchmark debt to income ratios of 29 and 41 percent were exceeded on FHA loans that were manually underwritten.

Apreva approved loans with excessive qualifying ratios without adequate compensating factors for four of the loans reviewed. Apreva's QC reviewer did not always include this deficiency in its reports. Our review disclosed the remarks on the Mortgage Credit Analysis Worksheets (MCAW) provided borrower qualification information rather than compensating factors to justify high ratios as required by HUD.

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B. Apreva failed to document the stability of income in accordance with HUD/FHA requirements.

Apreva did not verify and/or compute income as required by HUD for nine of the loans reviewed. Apreva's QC reviewer noted that the underwriter often overstated income due to errors in calculation and lack of supporting documentation.

C. Apreva failed to properly verify the source of funds used for the downpayment and/or closing costs.

Apreva did not comply with HUD's requirements regarding the source of borrower's downpayment funds for seven of the loans reviewed. Specifically, Apreva did not always ensure that:

- Required documentation was obtained and submitted to HUD. Apreva's QC reviewer noted the underwriter didn't always obtain adequate verification of funds.
- The borrower had sufficient funds to close the loan. Apreva's QC reviewer noted that the source of funds wasn't identified for a large deposit into the borrower's bank account.
- Downpayment gifts were adequately documented and verified. Apreva's QC reviewer noted cash gift funds weren't adequately documented. Our review disclosed that Apreva did not verify that non-profit gift funds are received into escrow before the seller's donation is provided to the non-profit as required by HUD.

D. Apreva failed to ensure compliance with HUD/FHA credit requirements.

Apreva did not comply with HUD's mortgage credit requirements for two of the loans reviewed. Apreva's QC reviewer noted that the underwriter didn't always:

- Identify the source of funds for a large liability paid off just prior to closing;
- Include all debt in the calculation of the ratios; or
- Obtain an explanation of derogatory credit.

E. Apreva failed to review appraisals in compliance with HUD/FHA requirements and/or resolve appraisal irregularities.

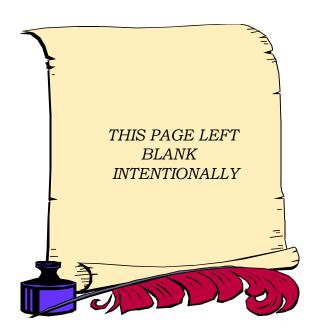
Apreva did not adequately review appraisals for unacceptable items for one of the files reviewed. The QC reviewer noted that a required pest inspection wasn't done prior to closing the loan.

F. Apreva failed to clarify and/or adequately document important file discrepancies.

The underwriter made numerous misstatements and errors on the Mortgage Credit Analysis Worksheets (MCAW) for five of the loans reviewed. Our review disclosed that:

- The underwriter didn't ensure that accurate and supported amounts were input into Loan Prospector, resulting in loan acceptance rather than being referred for manual underwriting or denied due to high ratios with lack of compensating factors;
- The underwriter's remarks were unsupported by file documentation;
- The underwriter approved a loan prior to receiving and verifying all required documentation; and/or
- Apreva included gift funds in its calculation of cash reserves. The QC reviewer noted that the inclusion of gift funds in cash reserves is contrary to HUD's requirements.

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Loans Originated By Other Mortgage Companies Using Apreva's Mortgagee Number

(Recommendation 3B.)

Loans currently at risk. (Four Loans)

FHA Case	Other Mortgage	Endorsement	Mortgage	Loan Status
Number	Company (ID Number)	Date	Amount	
561-7178048	Premium Mortgage	5/29/2001	\$109,924	Conveyed to
	Corporation (76283)			Insurer
561-7230665	Quickdraw Real Estate	7/26/2001	137,104	Commence
	Services, Inc. (79450)			Foreclosure
561-7318907	Priority Mortgage, Inc.	9/12/2001	144,130	Reinstated,
	(11585)			Now Current
561-7410910	Allied Home Mortgage	11/21/2001	133,406	Reinstated, Now
	Capital Corp. (75073)			Current
Total value of l	oans currently at risk		\$524,564	

Loans current or paid in full (31 Loans)

FHA Case	Originating Mortgagee	Endorseme
Number	(ID Number)	nt
		Date
431-3521781	E-Loan Of Oregon Inc. (15078)	5/31/2001
431-3543446	Mortgage Executives Inc. (16148)	9/6/2001
431-3568209	Mortgage Market Inc. (78243)	8/3/2001
431-3572509	Professional Mortgage Corp. (72607)	7/20/2001
431-3592923	E-Loan Of Oregon Inc. (15078)	8/8/2001
431-3597631	Mortgage Market Inc. (78243)	9/6/2001
431-3736590	Priority Mortgage Services LLC (16905)	5/6/2002
561-7164577	Capital Home Loans Inc. (79014)	1/3/2001
561-7172596	Professional Mortgage Corp. (72607)	3/29/2001
561-7184752	Capital Home Loans Inc. (79014)	4/2/2001
561-7188097	Capital Home Loans Inc. (79014)	7/18/2001
561-7194273	Capital Home Loans Inc. (79014)	5/21/2001
561-7196251	Capital Home Loans Inc. (79014)	5/31/2001
561-7197625	Capital Home Loans Inc. (79014)	5/14/2001
561-7212246	Capital Home Loans Inc. (79014)	5/21/2001
561-7219612	Capital Home Loans Inc. (79014)	6/5/2001
561-7287918	Gorkin Enterprises, Inc. (77177)	8/10/2001
561-7291719	Gorkin Enterprises, Inc. (77177)	9/22/2001
561-7301687	Priority Mortgage, Inc. (11585)	8/7/2001
561-7302119	Gorkin Enterprises, Inc. (77177)	8/7/2001

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FHA Case	Originating Mortgagee	Endorseme
Number	(ID Number)	nt
		Date
561-7311894	Gorkin Enterprises, Inc. (77177)	9/19/2001
561-7318907	Priority Mortgage, Inc. (11585)	9/12/2001
561-7319665	Gorkin Enterprises, Inc. (77177)	11/21/2001
561-7343244	Gorkin Enterprises, Inc. (77177)	10/10/2001
561-7353308	Allied Home Mortgage Capital Corp (75073)	7/8/2002
561-7410910	Allied Home Mortgage Capital Corp (75073)	11/21/2001
561-7435255	Woodinville Mortgage, LLC (17920)	12/20/2001
561-7499005	Allied Home Mortgage Capital Corp (75073)	8/1/2002
561-7507702	Guaranty Mortgage Corp. (11476)	5/2/2002
561-7512964	Woodinville Mortgage, LLC (17920)	5/14/2002
569-0536331	Willamette Mortgage Services Inc. (12099)	4/11/2002

Loan Correspondents For Apreva, Inc. (Recommendation 3D.)

Lender		FHA		Date
ID	Lender Name	Approved	Date Active	Terminated
10113	Red Inc	Active	2/4/97	
10546	Sullivan Mortgage Source Inc	Active	5/22/97	
10559	OMT Enterprises LLC	Active	5/28/97	
10655	Real Estate Financial Services Inc	Active	6/17/97	
10706	Discover Mortgage Company	Active	7/2/97	
10899	KDL Inc	Active	8/21/97	
11341	Majestic Mortgage Services	Active	12/12/97	
11451	First Rate Mortgage Inc	Active	1/20/98	
11476	Guaranty Mortgage Services Inc	Active	1/20/98	
11517	Northern Mortgage Inc	Active	2/4/98	
11585	Priority Mortgage Inc	Active	2/18/98	
12099	Willamette Mortgage Services Inc	Active	6/19/98	
12223	Accel Mortgage Corporation	Active	7/24/98	
12828	First Metropolitan Mortgage Co	Terminated	12/1/98	7/31/03
13572	Scheller Hess-Yoder and Associates	Active	5/12/99	
13987	Response Mortgage Services Inc	Active	7/14/99	
14159	Mortgage Broker Associates Inc	Active	7/16/99	
14175	Morgan Financial Inc	Active	7/17/99	
14987	Capstone Inc	Active	1/7/00	
15078	E-Loan Of Oregon Inc	Active	1/28/00	
15511	First Northwest Mortgage Corp	Active	4/11/00	
15514	Financial Advantage Corp	Active	4/11/00	
15742	Quintet Mortgage LLC	Active	5/12/00	
15844	Wellington Mortgage Trust Inc	Active	6/7/00	
15852	Compusel Inc	Active	6/8/00	
15978	Cascade Northern Mortgage Inc	Active	7/7/00	
16014	Mortgage Associates Inc	Terminated	7/19/00	7/1/02
16148	Mortgage Executives Inc	Terminated	8/14/00	8/13/02
16352	Pacific Northwest Mortgage Inc	Active	9/19/00	
16412	Schwab Financial Services Inc	Active	9/29/00	
16428	Hawlstead Mortgage Inc	Active	10/3/00	
16602	Fitkin Mortgage Corporation	Active	11/6/00	
16765	Olympic Mortgage Inc	Active	12/22/00	
16905	Priority Mortgage Services LLC	Active	2/1/01	
17171	Qfund Financial Inc	Terminated	4/18/01	10/3/03
17541	Allegiance Mortgage and Investment Co	Active	7/2/01	
17630	Town And Country Home Loans Inc	Active	7/30/01	
17920	Woodinville Mortgage LLC	Active	10/22/01	
17943	Professional Processing Northwest LLC	Active	10/30/01	
18109	Donna Brown Loan Services Inc	Active	12/12/01	

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Lender		FHA		Date
ID	Lender Name	Approved	Date Active	Terminated
18151	Pierce Mortgage Plus Inc	Active	12/28/01	
18277	Columbia First Mortgage Inc	Active	2/12/02	
18335	Metropolitan Financial Group Inc	Terminated	2/27/02	10/3/03
18364	Pathfinders Mortgage Inc	Active	3/4/02	
18389	Universal Mortgage Inc	Active	3/12/02	
18494	Qualified Residential Lending	Active	3/27/02	
18581	L K Cragun Inc	Active	4/18/02	
19181	Mortgage Lending Inc	Active	9/18/02	
19325	Barrett And Kashmar LLC	Active	10/31/02	
40246	Landmark Mortgage Company	Active	2/13/85	
64923	Pro American Financial Inc	Active	10/31/85	
71607	Edmonds Mortgage Incorporated	Active	12/17/87	
72607	Professional Mortgage Inc	Active	1/10/89	
73297	Alpine Mortgage Services Inc	Active	9/6/89	
75073	Allied Home Mortgage Capital Corp.	Active	9/26/91	
75692	Primewest Financial Ltd	Active	9/21/92	
76283	Premium Mortgage Corporation	Active	8/9/93	
76320	Certified Financial Services	Active	8/26/93	
76589	Mainstreet Mortgage Inc	Active	12/29/93	
77177	Gorkin Enterprises Inc	Active	7/13/94	
77527	Goldmark Financial Corp	Active	10/11/94	
78243	Mortgage Market Inc	Terminated	5/24/95	2/2/04
78341	Professional Mortgage Corp	Active	7/6/95	
79014	Capital Home Loans Inc	Active	4/1/96	
78944	Northwest Mortgage Group Inc	Active	3/7/96	
79450	Quickdraw Real Est Serv Inc	Active	8/13/96	